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Comment Letter on Amendment to NASD Order Display Proposal, December 2000

December 5, 2000

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

Re: Order Display Facility
(Amendment No. 8 to File No. SR-NASD-99-53)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on Amendment No. 8 to the proposed rule change[2] filed by the NASD, through its wholly-owned subsidiary, the Nasdaq Stock Market, to establish the Nasdaq Order Display Facility ("SuperMontage") and to modify the Nasdaq trading platform.

As we stated in our previous comment letters on the proposal,[3] the Institute supports the objectives of SuperMontage, in particular, increasing the transparency of limit orders in the Nasdaq market and the ability of those orders to interact with one another. Nevertheless, we have had reservations regarding several aspects of the proposal, including, most recently, two potential problems involving how orders would be prioritized for execution within SuperMontage. Our first concern related to the effect of an increase in the displayed size of an order on that order's standing. The second concern related to the effect of access fees charged by ECNs on the priority afforded their quotes.[4]

We are pleased that Nasdaq has proposed in Amendment No. 8 changes intended to address these concerns. In particular, Nasdaq is proposing to modify SuperMontage to protect the time priority of a market participant that increases its displayed size by placing time stamps on quote entries that would be used in determining their ranking in the execution algorithm relative to other quotes/orders at that price level. In addition, Nasdaq is proposing to modify SuperMontage to eliminate the per se treatment of ECN access fees. Instead, market participants would have the option to indicate that their order should be executed in a manner that accounts for an ECN's separate quote-access fee. We believe that these proposed changes are responsive to our concerns and we strongly support them. We also commend Nasdaq for its willingness to make changes that will increase the likelihood that SuperMontage will achieve its objectives.

Unfortunately, however, Amendment No. 8 also introduces additional changes to SuperMontage that, in our view, would significantly diminish the potential benefits of the proposed system. These changes include (1) the introduction of a new type of order, the "preferenced order," and (2) the introduction of a new execution algorithm for non-directed orders that would be based on price/size/time priority. For the reasons set forth below, the Institute strongly opposes these changes and recommends that they be eliminated from the proposed SuperMontage system.[5]

Preferenced Orders

Amendment No. 8 contains a proposal to create a new type of order called a "preferenced order." A preferenced order would allow a market participant to designate a particular quoting market participant against which their order is to be executed or delivered. Preferenced orders would be executed within the SuperMontage system in the same queue as non-directed orders and would be considered liability orders.

The Proposing Release states that one of the purposes of preferenced orders is to maintain a function within SuperMontage similar to that which currently exists in Nasdaq, i.e., using SelectNet to preference orders to market makers or ECNs who are quoting at the BBO or away from the BBO. The Proposing Release also states that this function assists a market maker that is "working" an institutional order as that market maker may send a preferenced SelectNet message to a market participant who is quoting away from the BBO because the market maker believes that market participant has greater size to offer.

The Institute believes that the introduction of preferenced orders is unnecessary to accomplish this goal. Directed orders currently provide, and will continue to provide, this function under the proposed SuperMontage system. In particular, a market participant will be able to send an order to a particular quoting market participant at any price through a directed order in the Nasdaq market. Directed orders, which will often be non-liability orders, also provide an opportunity for market makers to explore for greater size. Preferenced orders, in contrast, will always be liability orders. Thus, it is not clear how they could be used for this purpose. Moreover, even if they could, they do not appear to offer any additional functionality in this regard over directed orders.

While offering little, if any benefits, allowing market participants to send preferenced orders inside the SuperMontage system would undermine the concept of price/time priority by allowing market participants to preference market participants that lack priority status, and thus damage the integrity of the Nasdaq market. It is further likely that such orders could be used as a mechanism to facilitate such dubious practices as internalization and payment for order flow. We therefore strongly recommend that preferenced orders be eliminated from the proposed SuperMontage system.

Price/Size/Time Priority

Amendment No. 8 introduces a new algorithm for non-directed orders. In addition to providing two algorithms that follow price/time priority (one of which would take ECN access fees into account), SuperMontage also would include a new price/size/time priority algorithm. The Institute supports the two price/time priority algorithms because they would resolve the dispute over how to treat access fees within SuperMontage in a fair and equitable manner while maintaining adherence to the principle of price/time priority. Nothing, however, compels the introduction of a third alternative based on price/size/time. Moreover, like preferenced orders, the price/size alternative is seriously flawed because it would undermine the concept of price/time priority. Rather than rewarding market participants for submitting price improving orders, a price/size algorithm would undermine the status of those orders. For example, if a market participant placed an order in SuperMontage for 1,000 shares at a certain price, another market participant could step ahead of this order and receive priority status in the queue by placing an order at the same price at a quantity of just one unit of trading higher.

Rewarding market participants for displaying greater size is an enviable goal; however, this should not be at the expense of the priority of market participants who were first in time in the queue. Ranking orders/quotes based on displayed size also will have little effect on the ability of market participants to complete large orders. Market participants will still have the ability to sweep through a certain price level under the two remaining algorithms in order to complete a transaction for a large number of shares as well as have the option to utilize directed orders to send an order to a market participant displaying greater size. The price/size option thus would appear to offer little, if any, benefits. We therefore recommend that it be eliminated from the proposed SuperMontage system.

Conclusion

The Institute is pleased that Amendment No. 8 addresses our most significant concerns with the previous versions of SuperMontage.[6] We are seriously concerned, however, with the proposed additions of preferenced orders and the price/size algorithm of SuperMontage. The Institute recommends that SuperMontage be adopted without these unnecessary and problematic features.

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 Isaac C. Hunt, Jr., Commissioner
The Honorable Paul R. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Paul F. Roye, Director, Division of Investment Management
Securities and Exchange Commission

Richard G. Ketchum, President
The Nasdaq Stock Market, Inc.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,325 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.232 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] Securities Exchange Act Release No. 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000) ("Proposing Release").

[3] See Letters from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 11, 2000 and April 20, 2000 (File No. SR-NASD-99-53).

[4] See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Arthur Levitt, Chairman, Securities and Exchange Commission, dated October 24, 2000.

[5] We also question the wisdom of introducing new elements to SuperMontage at this stage of the process, unless they are intended to respond to specific concerns expressed by commenters (as the changes regarding increases in displayed size and ECN access fees are). We are only aware of one commenter who even suggested introducing the concept of preferenced orders and are unaware of any comments that would necessitate – or even suggest the advisability of – price/size/time priority.

[6] We also wish to reiterate our earlier comments that further enhancements to SuperMontage that would increase the number of price levels displayed in the system, particularly after the conversion to decimalization is completed, should be pursued. In addition, we reiterate our opposition to the "built-in" internalization capability of the proposed system, which would be preserved in all three of the proposed execution algorithms under Amendment No. 8. Finally, we are pleased that Nasdaq is proposing certain clarifying amendments in Amendment No. 8 regarding UTP exchanges. We encourage Nasdaq to continue working with market participants to develop an approach that would treat UTP exchanges in a mutually satisfactory manner.
