

## Comment Letter on SEC Proposal Concerning SROs, April 2001

April 6, 2001

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

**Re: Proposed Rule Changes of Self-Regulatory Organizations  
(File No. S7-03-01)**

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on proposed Rule 19b-6 under the Securities Exchange Act,<sup>2</sup> which would amend the requirements applicable to self-regulatory organization ("SRO") filings of proposed rule changes with the Securities and Exchange Commission.

The SRO rulemaking process is crucial to the development of an efficient market structure, the orderly functioning of the markets, and the protection of investors. The Commission recognized the importance of this process in the Proposing Release when it stated that "the administrative notice and comment procedure helps to ensure that interested persons have an opportunity to provide input into SRO actions that may have a significant impact on market participants and individual investors."<sup>3</sup>

The Institute therefore supports amendments to the rulemaking process that would improve the ability of interested persons to submit comments on SRO actions. Nevertheless, we have reservations regarding several aspects of the proposed rule, including the new category of rules eligible for immediate effectiveness. In addition, we are extremely disappointed that the Commission neglected to propose changes to one of the most significant aspects of the rulemaking process -- the length of time allocated to interested persons to comment on SRO proposed rule changes. The Institute recommends that this issue be addressed prior to adoption of the proposed rule.

Our specific comments follow below.

### A. Immediate Effectiveness of Trading Rules

The proposal would allow proposed rule changes governing most "trading rules" to become effective upon filing under Section 19(b)(3) of the Exchange Act.<sup>4</sup> Only those trading rules that make "fundamental structural changes" to the market, and that significantly affect the protection of investors or the public interest or impose a significant burden on competition, would not be eligible to become immediately effective and would be subject to the regular notice and comment period under Section 19(b)(2) of the Exchange Act.

The Institute opposes immediate effectiveness for such a broad range of rule changes. There have been numerous instances where proposed rule changes, many addressing matters specifically cited in the Proposing Release as examples of rules that would be eligible for immediate effectiveness,<sup>5</sup> have had a major impact on market participants, albeit often unintended, which necessitated further industry discussion prior to approval and implementation of the rule change. The Institute is concerned that many of the filings that would become immediately effective under the proposed rule could result in adverse consequences for investors without any opportunity for input from the public or review by the Commission.

To give an example, Nasdaq recently implemented a rule change extending its trade reporting and quotation dissemination facilities in connection with after-hours trading.<sup>6</sup> It appears from the Proposing Release that this change would have been eligible under the proposal for immediate effectiveness (as a rule in connection with the extension of the close of trading). As it turned out, Nasdaq's extension of its facilities could have seriously impaired the ability of mutual funds to price their portfolios, an impact which was not

obvious to Nasdaq upon filing of the proposed rule change. As a result of communications between the fund industry and Nasdaq about the impact of these changes, Nasdaq delayed implementation of the proposed rule change until funds and their vendors were able to make the adjustments necessary to ensure that the pricing process would not be disrupted. Under the regime that the proposal would establish, this might not have been the case, to the detriment of funds and their shareholders.

The Institute recognizes that the Commission would retain the authority to abrogate a rule change that has become effective if it determines that abrogation is necessary or appropriate in the public interest or for the protection of investors,<sup>7</sup> or, under the current proposal, the rule change makes fundamental structural changes and should not have been filed for immediate effectiveness. However, it is questionable whether many proposed rule changes will meet these high standards. In addition, the fact that a rule change does not rise to the level necessary for abrogation does not mean that it could not have been improved in certain respects. Such improvements, however, will become rarer in the absence of public scrutiny.

Another recent example that we believe illustrates this point was the approval by the Commission last December of amendments to NASD rules to permit the inclusion of certain unit investment trusts ("UITs") in Nasdaq's Mutual Fund Quotation Service.<sup>8</sup> The Institute had several comments on the amendments – comments that we believe would have greatly enhanced the proposal. While the fact that the rule did not reflect those comments does not warrant its abrogation, the failure of the Commission to even consider our comments is hardly conducive to good rulemaking.

Accordingly, the Institute recommends that the proposal be revised to delete the provision concerning immediate effectiveness of "trading rules." If, however, the Commission is not inclined to make this change, we would recommend that, at a minimum, such rules not become operative until 30 days after the date of filing, similar to the current 30-day delayed operational date for non-controversial filings. A delayed operational date would provide a "timeout" to allow interested persons the opportunity to examine the filing and determine whether it could have effects on the securities markets that need to be addressed.<sup>9</sup>

## B. Rules Eligible for Immediate Effectiveness

The Proposing Release requests comment on whether there are other types of proposed rule changes that the Commission should consider making eligible for immediate effectiveness, such as proposed rule changes relating to listing standards and new products. The Institute believes that, like many trading rules, proposed rule changes relating to these types of issues could have major impacts on investors and address fundamental concerns of investors. Therefore, we do not believe that investors and market participants would be well served by making other types of rule changes eligible for immediate effectiveness.<sup>10</sup>

## C. Public Comment Period

The Institute is extremely disappointed that the Commission, while proposing major changes to the SRO rulemaking process, has left untouched maybe the most significant aspect of the process affecting investors -- the time period provided for public comment. Currently, once a proposed rule change is properly filed with the Commission, the Commission will send the proposal to the Federal Register for publication and interested persons are typically provided only 21 days, beginning on the date after the notice appears in the Federal Register, to comment on the proposed rule change.

As the Institute has noted on several occasions in the past,<sup>11</sup> a 21-day comment period is woefully inadequate to develop detailed, substantive and well-considered comments before the close of the comment period on important SRO proposed rule changes. Given the amount of resources the SEC has devoted to efforts to restructure the U.S. securities markets, it would seem fundamental that the SEC would seek to provide "interested persons" with a bona fide opportunity to submit ... views and arguments" concerning proposed rule changes affecting the securities markets.<sup>12</sup> Providing the public with only 21 days to comment on significant proposals does not constitute a meaningful "opportunity" to comment.

This is not a theoretical matter – there have been numerous instances in recent years in which significant proposed rule changes have been published with only a 21-day comment period. (The attached appendix lists some of these proposed rule changes). Ironically, in many of these cases, the SRO in question itself spent months, or even years, developing the proposal. Surely the investing public – whom the Commission is charged with protecting – deserves some, if not the same, level of accommodation.

If the Commission truly wants to improve the SRO rulemaking process, the first step must be to extend the time permitted for public comment. We therefore urge the Commission to lengthen the public comment period, at the very least for those filings that would make fundamental structural changes and for other non-trading rules that would be subject to the regular notice and comment period under Section 19(b)(2) of the Exchange Act.

\* \* \*

The Institute appreciates the opportunity to comment on this very important proposal. 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

Attachment

cc: The Honorable Laura S. Unger, Chairman  
The Honorable Isaac C. Hunt, Jr., Commissioner  
The Honorable Paul R. Carey, 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

## Appendix

### Examples of Significant Rule Filings with 21-Day Comment Periods

1) NYSE Direct+ Proposal  
June 2000

Proposed new facility for the automatic execution of certain limit orders on the NYSE. Several days of the comment period also fell over Fourth of July holiday.

2) Nasdaq Order Display Facility (SuperMontage) Proposal  
Originally filed December 1999

Proposal to create new facility for the trading of securities in the Nasdaq Stock Market. Several year effort on the part of market participants to develop proposed system.

3) NASDR Request for Comment on Modernization of NASD Rules  
October 1998

Broad request for comment on whether any NASD rules or by-laws should be repealed because they are obsolete, should be modernized in light of technological or industry developments, or should distinguish between institutional and retail customers.

4) NASDR Bond Fund Volatility Ratings Proposal<sup>2</sup>  
November 1998

Took almost two years for NASDR and SEC to develop proposal due to controversy surrounding it and the complexity of the issue. Several days of the comment period also fell over Thanksgiving holiday.

5) Amendments to Non-Cash Compensation Arrangements<sup>3</sup>  
September 1997

Proposed amendments to NASD rule relating to non-cash compensation paid in connection with the sale of investment company securities. NASD spent years developing the proposal.

#### ENDNOTES

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,391 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 \$7.2 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

<sup>2</sup> Securities Exchange Act Release No. 43860 (January 19, 2001), 66 FR 8912 (February 5, 2001) ("Proposing Release").

<sup>3</sup> Proposing Release, note 30 and accompanying text.

<sup>4</sup> The term "trading rule" is defined broadly to include SRO rules that "govern the trading of securities on the exchange or association

or its facilities."

<sup>5</sup> The Proposing Release provides examples of trading rules that would be eligible for immediate effectiveness that include, among other things, rules extending the close of trading, affecting the crossing of orders or the priority of orders, mandating executions of orders up to a particular size at the displayed bid or offer, or affecting the operation of certain small order execution systems.

<sup>6</sup> Securities Exchange Act Release No. 42003 (October 13, 1999).

<sup>7</sup> Securities Exchange Act Section 19(b)(3)(C).

<sup>8</sup> Securities Exchange Act Release No. 43749 (December 20, 2000). This proposed rule change also raised serious questions about the rulemaking process, specifically the process through which the amendments to the proposed rule change were adopted. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 9, 2001 (File No. SR-NASD-00-59) (Nasdaq Mutual Fund Quotation Service), a copy of which is attached.

<sup>9</sup> The proposal provides that if an SRO wants to make a substantive amendment to a proposed rule change filed for immediate effectiveness, the SRO must refile the proposed rule change in its entirety. At that point, the 60-day period that the Commission has to abrogate a rule change would run from the date of filing of the new amended filing, and the proposed rule change, in its entirety, would be deemed effective upon filing of the amendment and not from the date of the initial filing. Consistent with this, the Institute recommends that if an SRO files a substantive amendment to a proposed rule change, our recommended 30-day delayed operational date should also begin from the date of the filing of the amendment.

<sup>10</sup> The proposal also would require the issuance of a release relating to proposed rule changes within 10 business days of filing. The Institute does not object to expediting the issuance of a release relating to an SRO proposed rule change. However, in order to ensure that the Commission can properly review a filing within the prescribed time period, the Institute urges that the appropriate Divisions within the Commission better coordinate their efforts to examine filings.

<sup>11</sup> See, e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 9, 2001 (File No. SR-NASD-00-59) (Nasdaq Mutual Fund Quotation Service), a copy of which is attached. See also Letters from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated April 20, 2000 (File No. SR-NASD-99-53) (Nasdaq Order Display Facility) and July 6, 2000 (File No. SR-NYSE-00-18) (NYSE Direct+).

<sup>12</sup> See Section 19(b)(1) of the Securities Exchange Act of 1934.