Independent Directors Council

Promoting Excellence in Fund Governance

ICI Supports Proposals to Keep Securities Markets Liquid, Transparent, January 2005

January 26, 2005

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

Re: Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

The Investment Company Institute [1] appreciates the opportunity to comment on the Securities and Exchange Commission's reproposed Regulation NMS, [2] which is intended to enhance and modernize the regulatory structure of the U.S. equity markets. Regulation NMS is an essential step in the development of a market structure that best serves all investors.

As the Institute stated in our previous comment letter on the Regulation NMS proposal, [3] because our members are investors of over $7.8 trillion of assets on behalf of over 87 million individual shareholders, we have a strong interest in ensuring that the regulatory structure that governs the securities markets encourages liquidity, transparency and price discovery in order to facilitate the trading of institutional-sized orders. As the Release notes, "given that millions of individuals invest in NMS stocks directly through [institutional investors], it is vitally important for the NMS to promote depth and liquidity for the trading of large orders." [4] We commend the Commission for undertaking such an extensive examination of the structure of the U.S. equity markets and for reproposing Regulation NMS to provide an additional opportunity to comment on the details of such a significant proposal.

Given that the majority of changes in the reproposal center on the trade-through rule, we focus our comments on that proposed rule, specifically on whether there is a need for a trade-through rule and the scope of such a rule. As discussed in greater detail below, the Institute strongly supports the

establishment of a uniform trade-through rule across all market centers and for all types of securities, including Nasdaq-listed securities. In addition, we strongly support the goals of the proposed depth of book alternative (i.e., full protection for displayed and accessible limit orders, strong linkages between markets and the opportunity for automated executions at the best available prices). Our members have differing views on whether the optimal path towards achieving those goals is through adoption of the proposed "top of book" or "depth of book" alternative. While there are strong arguments for both of these alternatives, we believe it is imperative that the Commission adopt one of the proposed versions of a marketwide trade-through rule, as either alternative is preferable to the status quo. Our specific comments follow. [5]

Trade-Through Rule Proposal

The proposed trade-through rule would require an order execution facility, national securities exchange and national securities association, with regard to the trading of "NMS Stocks," to establish, maintain, and enforce policies and procedures reasonably designed to prevent the purchase or sale of an NMS Stock at a price that is inferior to a better price displayed on another market.

Need for Trade-Through Rule

The Institute strongly supports the establishment of a marketwide trade-through rule. As the Institute discussed in detail in its 2004 Regulation NMS letter, such a rule represents a significant step in providing protection for limit orders. By affirming the principle of price priority, a trade-through rule should encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market depth and liquidity. A trade-through rule also would increase investor confidence in the securities markets by helping to eliminate an impression of unfairness when an investor's order executes at a price worse than the displayed quote. For these reasons, we strongly recommend that the Commission adopt a trade-through rule for the securities markets.

Critics of a trade-through rule contend that the adoption of such a rule would, among other things, dampen competition between markets. We recognize that achieving the ultimate balance between competition among markets and regulation of those markets is a difficult challenge. We believe, however, that allowing markets to trade in isolation from one another without the benefit of a trade-through rule is not the best result for investors. Moreover, it must be recognized that the goal of facilitating competition among markets can at times be inconsistent with the more important goal of facilitating competition among orders.

Application of Trade-Through Rule to Nasdaq-Listed Securities

The reproposed trade-through rule would apply uniformly to all market centers and would apply to all NMS securities, including Nasdaq-listed securities. As reflected in our 2004 Regulation NMS letter, the Institute continues to support such an application of the trade-through rule. [6]

The Release notes that several commenters on the original proposal stated that they believe it is unnecessary to apply a trade-through rule to Nasdaq-listed securities because those securities have, for the most part, functioned efficiently without a formal trade-through requirement and that a broker-dealer's best execution obligations obviates the need for a strict trade-through rule across all market centers. The Institute continues to believe that there is significant value in protecting a displayed price from trades occurring at inferior prices across all markets and in all types of securities. A uniform trade-through rule would affirm the principle of price priority and the protection of the best prices for all markets. We believe it would be anomalous to provide trade-through protection to only a certain group of investors, based solely on the type of security and market in which they invest. A uniform trade-through rule also would provide an additional layer of protection for investors in the execution of their orders over and above a broker's best execution obligations. Finally, as the Release notes, trade-throughs do occur in Nasdaq-listed securities. A uniform rule could prevent such trade-throughs from occurring and, if they do occur, could provide effective policies and procedures for obtaining restitution. For these reasons, we strongly recommend that the Commission adopt a uniform trade-through rule that applies across all market centers and to all types of NMS securities, including Nasdaq-listed securities.

"Top of Book" and "Depth of Book" Alternatives

The Release sets forth two alternatives to the proposed trade-through rule and requests comment on which alternative would best advance the principle of limit order protection while preserving intermarket competition and avoiding practical implementation problems. The first alternative ("top-of-book" alternative) would protect only the best bids and offers ("BBOs") of the exchange SROs, Nasdaq, and the NASD's Alternative Display Facility ("ADF"). The second alternative ("depth-of-book" alternative) also would protect the BBOs of the various exchange SROs, Nasdaq and the ADF, and would additionally protect the depth of book quotations at prices beyond the best bid and offer that a market voluntarily disseminates in the consolidated quotations stream.

The Institute strongly supports the goals of the depth of book alternative, and believes that it would be beneficial for market centers to work towards the implementation of its most significant features (i.e., full protection for displayed and accessible limit orders, strong linkages between markets and the opportunity for automated executions at the best available prices). Our members have differing views, however, on whether the optimal path towards achieving those goals is through adoption of the proposed "top of book" or "depth of book" alternative.

Several Institute members believe that the Commission should adopt the depth of book alternative. They believe that this approach would best advance the principle of limit order protection, thereby

increasing the benefits of the proposed trade-through rule. In particular, protecting quotations at multiple price levels would provide greater protection to displayed limit orders which, in turn, would be more likely than the top of book alternative to encourage increased use of such orders.

In addition, the depth of book alternative would eliminate situations that would arise under the top of book alternative where liquidity in certain markets would be bypassed. For example, assume Market A is displaying 500 shares at the national best offer of $20.02 (and also has offers at each price level below the best offer), Market B is displaying 500 shares at $20.03 (its best offer) and 20,000 shares at $20.04, Market C is displaying 300 shares at $20.05 (its best offer), and Market D is displaying 800 shares at $20.07 (its best offer). Under the top of book alternative, if an order arrives at Market A to buy a significant amount of shares that would satisfy all the displayed liquidity in the other markets, Market A would only be required to send orders to satisfy the best offers at Markets B, C, and D. The 20,000 share order on Market B, even though it is for a significant amount of stock, would be ignored and would remain unexecuted in favor of inferior-priced orders. Our members supporting the depth of book alternative believe that such a result would run counter to the Commission's goal of providing incentives for investors to place limit orders into the securities markets.

Other Institute members believe that the best way to support the goals of the depth of book alternative is for the Commission to take the incremental step of adopting the top of book alternative. They are concerned that inexperience with depth of book intermarket trade through protection raises uncertainties regarding the impact of the depth of book alternative on institutional trading. These members also believe that the competition created by the top of book alternative ultimately will drive the securities markets to implement the features of a depth of book market structure, which is a more favorable means of achieving the goals of the depth of book alternative than through a specific government mandate. In this regard, these members note that the debate over Regulation NMS and the proposal to limit the protections of a trade-through rule to automated quotes has prompted the New York Stock Exchange to develop a hybrid market proposal, which incorporates features of an automated market into the NYSE's current manual market structure. [7]

There are strong arguments for both of the proposed alternatives. Regardless of which alternative the Commission ultimately chooses, we urge the Commission to adopt one of these approaches, as either alternative is preferable to the status quo, which does not protect, or provide incentive to display, limit orders in the national market system.

Application of Trade-Through Rule Solely to NBBO

Critics of the top of book and depth of book alternatives have suggested that the Commission limit the protections of the trade-through rule solely to the national best bid and offer ("NBBO"). The Institute strongly opposes such a proposal.

Limiting price protection solely to the NBBO would, in effect, make any trade-through rule a fallacy. As soon as an order at the NBBO is executed, which can be for an amount as small as 100 shares displayed in a single market, all other investor orders in all other markets would not be provided protection. We believe such a result would be inconsistent with the Commission's goals in adopting a trade-through rule.

Proposed Exceptions to Trade-Through Rule

Although the Institute did not support the proposed opt-out exception in the original Regulation NMS proposal, our 2004 Regulation NMS comment letter noted that it is extremely important that any market structure facilitate the execution of institutional-sized orders. [8] We therefore strongly support the exceptions to the trade-through rule for "benchmark" orders and "intermarket sweep" orders that are designed to help ensure that the trade-through rule is feasible for institutional orders.

The benchmark order exception would except from the provisions of the trade-through rule the execution of an order at a price that was not based, directly or indirectly, on the quoted price of an NMS Stock at the time of execution. To comply with this exception, the material terms of the order also must not be reasonably determinable at the time the commitment to execute the order was made. The Release notes that a common example of a benchmark order is a volume weighted average ("VWAP") order. The Institute seeks clarification that the benchmark order exception would provide flexibility for institutions to execute other types of average price trades outside of the provisions of the trade-through rule. Specifically, our members report that while they execute trades on a VWAP basis, they also often execute other types of average price trades, including variations on a VWAP trade (e.g., trades that improve upon the VWAP price by a certain amount). Similar to a regular VWAP order, the price of such orders would not be based on the quoted price of an NMS Stock at the time of execution and the material terms of the trade would not reasonably be determinable at the time the commitment to execute the order was made.

The Institute also supports the intermarket sweep order exception. The intermarket sweep order exception would allow market participants to simultaneously access multiple price levels at different trading centers. [9] Specifically, the exception would enable trading centers that receive sweep orders to execute those orders immediately, without regard for better-priced quotations displayed at one or more other trading centers and without waiting for better-priced quotations in other markets to be updated. As the Release notes, such an exception can be used to execute block transactions, as long as orders have been routed to access all better priced protected quotations. Because this exception would require an attempt to access all better-priced protected quotations up to their displayed size, we believe that it is consistent with the principle of protecting all orders priced better than the block transaction. At the same time, this exception would permit institutional investors to continue to execute large sized orders in an efficient manner. [10]

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The Institute appreciates the opportunity to comment on reproposed Regulation NMS. Any questions regarding our comments may be directed to the undersigned at 202-371-5408 or to Elizabeth Krentzman, General Counsel, at 202-326-5815.

Sincerely,

Ari Burstein
Associate Counsel

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

Annette L. Nazareth, Director
Robert L. D. Colby, Deputy Director
Division of Market Regulation

Paul F. Roye, Director
Division of Investment Management

Securities and Exchange Commission

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry.

[2] Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004) ("Release").

[3] See Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004 ("2004 Regulation NMS letter").

[4] Release at p. 8.

[5] For the Institute's views on the other Regulation NMS proposals, as well as aspects of the proposed trade-through rule not addressed in this letter, see 2004 Regulation NMS letter, supra note 3.

[6] The Institute also supports the Commission's decision in the reproposal to limit the trade-through rule's protection to automated and accessible quotations and to eliminate the proposed limitation on trade-through amounts for manual markets and quotations. We believe the proposed definition of an

automated quotation addresses our concerns over including in a trade-through rule those quotations that are not truly automated. Similarly, the Institute supports the Commission's decision to set forth requirements for a trading center to qualify as an "automated trading center."

[7] While several members support the top of book alternative in order to preserve the choice of market in which to execute their orders, all of our members agree that the NYSE should make certain changes to its hybrid market proposal to provide investors with the necessary protection for limit orders placed on the Exchange and to provide incentive to place orders into that market. Specifically, as the Institute stated in its comment letters on the hybrid market proposal, certain features of the hybrid market, most significantly, the lack of priority for displayed investor orders, will result in a disincentive to place limit orders on the Exchange or to utilize the "sweep" function of the hybrid market. See Letters from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated September 22, 2004 and December 13, 2004.

[8] The Institute strongly supports the Commission's decision to eliminate the "opt-out" exception to the proposed trade-through rule. The opt-out exception would have permitted a person for whose account an order is entered to opt-out of the protections of the trade-through rule by providing informed consent to the execution of their orders in one market without regard to the possibility of obtaining a better price in another market. As the Institute stated in its 2004 Regulation NMS letter, if the Commission restricts the trade-through rule to automated quotes and adopts a manual quote exception, then the opt-out exception would be unnecessary. The elimination of any protection for manual quotations in the reproposal achieves this objective. In addition, as the Release notes, given the proposed exceptions to the trade-through rule that would facilitate the execution of institutional-sized orders, the need for an opt-out exception is significantly reduced.

[9] An intermarket sweep order is defined as a limit order that meets the following requirements: (1) the limit order is identified as an intermarket sweep order when routed to a trading center, and (2) simultaneously with the routing of the limit order, one or more additional limit orders are routed to execute against all better-priced protected quotations displayed by other trading centers up to their displayed size.

[10] The reproposal also includes several exceptions that are designed to limit the application of the trade-through rule to quotations that are truly automated and accessible and that would address the difficulties of protecting quotations displayed by other trading centers. Specifically, the reproposal would include exceptions for quotations displayed by markets that fail to meet the response requirements for automated quotations and for "flickering" quotations. The Institute supports these exceptions. As the Release notes, these exceptions would provide trading centers with needed flexibility to deal with a trading center that is experiencing systems problems, rather than forcing smoothly-functioning trading centers to slow down for a problem market. The exceptions also would address false indications of trade-throughs that in actuality are attributable to rapidly moving quotations.

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