



INVESTMENT COMPANY INSTITUTE

CRAIG S. TYLE
GENERAL COUNSEL

July 28, 1998

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

*Re: Regulation of Exchanges and
Alternative Trading
Systems (File No. S7-12-98)*

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rules governing "alternative trading systems" (or "ATSs") and national securities exchanges, including the proposal to allow national securities exchanges and securities associations to operate certain pilot trading systems.² In general, the Institute supports the proposals, which appear to take into account comments we made in our letter on the Commission's 1997 concept release on the regulation of securities exchanges.³

More specifically, we are pleased that the Commission appears to have abandoned the more radical approach discussed in the Concept Release. Under that approach, all ATSs would have been required to register as exchanges, which, in turn, would have been categorized in one of three proposed regulatory "tiers." While we concur with the Commission's view that changes in the marketplace warrant modernization of the regulations that govern the marketplace, it is important that the Commission act with some degree of caution. Obviously, it is not possible to anticipate all the effects of rule changes in this area. Thus, the SEC should

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,182 open-end investment companies ("mutual funds"), 439 closed-end investment companies and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.993 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

² Release No. 34-39884 (April 17, 1998) (the "Proposing Release").

³ See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated October 3, 1997 (File No. S7-16-97) ("1997 Comment Letter"), commenting on Release No. 34-38672 (May 23, 1997) (the "Concept Release").

avoid taking actions that are too sweeping in nature and that could have unintended consequences.

The Institute's specific comments on the proposal follow.

I. General Approach to Regulating Alternative Trading Systems

Under the SEC's proposal, alternative trading systems could choose whether to be regulated as exchanges, or to remain broker-dealers (in which case they would be subject to additional regulatory requirements under proposed Regulation ATS). For the reasons noted above, the Institute believes that this approach is preferable to a more sweeping one that would mandate that ATSs be registered as national securities exchanges.

As a practical matter, it appears that most ATSs will choose to remain registered as broker-dealers. This will enable them to retain their institutional customers, and to avoid restrictions on their corporate structures and on trading non-listed securities. Consequently, most of our comment letter will focus upon issues concerning ATSs that would be covered by proposed Regulation ATS.⁴

II. Display of Institutional Orders

Under the SEC's proposals, ATSs that meet specified volume thresholds with respect to specific "covered securities" would be required to publicly disseminate best-priced orders in those securities, including orders entered by institutions and non-market makers.⁵ The Institute had previously opposed mandatory exposure of institutional orders, noting that ATSs serve as broker-dealers, which traditionally have had the discretion to "work" an order on behalf of a customer without exposing that order. We also noted that, to the extent the Commission adopts rules requiring ATSs to accept retail customers, concerns over "two-tier" or "hidden" markets would be minimized.⁶

Nevertheless, upon further reflection, the Institute would support proposed Rule 301(b)(3), which would require display of best-priced orders, including orders of institutions.

⁴ The Proposing Release suggests that an ATS might choose to register as an exchange so that it can participate in the National Market System and, in particular, share in Consolidated Tape Association revenues. Proposing Release at 61. The Institute questions why this benefit should be limited to ATSs that register as exchanges. As we have previously noted, in order to create a truly national market, the Commission should act to remove regulatory barriers to the creation of linkages between all components of that market -- including ATSs. 1997 Comment Letter at 6.

⁵ Specifically, the requirement would apply to ATSs that account for more than ten percent of the average daily trading volume of a security for four out of six months, on a security-by-security basis. The Proposing Release requested comment on whether the requirement should apply on an aggregate basis to *all* securities traded by an ATS that satisfies certain aggregate volume requirements. The Institute believes instead that the display requirement should apply to all ATSs and all securities traded thereon. Such a standard would be easier to apply in practice and would discourage the routing of orders to systems solely in order to avoid display.

⁶ 1997 Comment Letter at 3.

We believe that such a requirement would strengthen the overall transparency and liquidity of the market. Our support for the Commission's proposal is premised, however, on the retention of the "reserve size" feature and on permitting identification of the ATS, rather than the ATS' customer, as the entity placing the order. Both the reserve size feature and anonymity of the customer were components of the rule changes recently proposed by Nasdaq, which the Institute strongly supported.⁷ The reserve size feature, in addition to providing mutual funds and other investors with greater flexibility, may well enhance liquidity, by encouraging the entry of orders close to the clearing price (because such orders should not incur the market impact costs of publicly disclosed orders). It also preserves the goal of price-time priority, as only those orders that *are* publicly disclosed will have time priority. Preserving anonymity of the customer is important because, without this feature, mutual funds frequently would be forced to reveal information concerning their trading strategies by entering orders onto ATSs. Because this would be detrimental to the interests of the funds shareholders, funds would likely seek to minimize the entry of such orders, which would, in turn, reduce overall transparency and liquidity in the market.

III. Access to Alternative Trading Systems

The SEC's proposals would impose two types of access requirements on ATSs. First, the proposal would require ATSs to provide broker-dealers that are not customers of the ATS the ability to execute against best-priced orders. Second, ATSs that exceed certain volume thresholds would be required to provide "fair access" to persons who wish to become direct customers of the ATS.

The Institute does not object to providing non-customer broker-dealers the ability to execute against best-priced orders. ATSs should, however, be permitted to charge a reasonable fee for such access. Otherwise, such broker-dealers would be able to "free ride" on the fees paid by the ATS' customers. The SEC's proposal would limit any such fee to the lower of (1) the maximum permitted by the ATS' SRO and (2) the fee charged to a substantial portion of the ATS' broker-dealer subscribers. The Institute believes that this latter requirement is unnecessarily restrictive and instead recommends that ATSs simply be required to comply with any SRO rules limiting fees.⁸

With respect to "fair access," the Institute continues to question the need for such a requirement. As we stated in our 1997 Comment Letter, there are already several ATSs (four

⁷ See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 8, 1998 (File No. SR-NASD-98-17).

⁸ The Institute likewise believes that market makers should be able to assess liquidity fees when their quotes are "hit." The adoption of the order handling rules has blurred the distinction between orders and quotes and, consequently, has accelerated moves towards compensating broker-dealers on a commission basis, as opposed to a spread basis. We recognize the potential for confusion, however, if these liquidity fees are not included in displayed quotations. One option that the Commission may wish to consider is to have the relevant SRO collect a fixed liquidity fee on behalf of ATSs and market makers, which could then rebate a portion of those fees to their customers pursuant to individual contractual arrangements.

when the letter was written, six as of the date of the Proposing Release⁹), and there do not appear to be any material barriers to entry. In response, the Proposing Release cites a single complaint to the NASD, which is apparently still pending (and which, of course, begs the question of what constitutes an "unreasonable denial of access").¹⁰

If the Commission nevertheless believes that it is appropriate to impose fair access requirements on ATSS, the Institute recommends that the proposal be modified and clarified in certain respects. First, the volume thresholds should be raised. The Concept Release stated that discriminatory access could be a problem where an ATS has "no other serious competitor." This appears limited to situations in which an ATS has a dominant market share. Thus, the Institute would suggest a much higher threshold for when ATSS would become subject to the fair access requirement, perhaps where an ATS handles 50% or more of the volume in a security.

Second, the SEC should clarify that the standards for access can take into account any factors that are relevant to credit or other forms of counterparty risk. This is of obvious importance to customers of an ATS.

Third, the Institute does not believe that the SEC should provide for a "right of appeal" of a denial of access. This adversarial process is likely to be highly burdensome both to ATSS and to the Commission. The ICI recommends instead that any complaints be treated no differently than other complaints against registered broker-dealers, and handled by the appropriate SRO or the Commission, as the case may be.

IV. Other Requirements for Alternative Trading Systems

Under the SEC's proposal, ATSS that meet certain volume thresholds would be required to adopt certain procedures with respect to capacity, integrity and security. As we noted in our 1997 Comment Letter, the Institute believes that competitive pressures will generally suffice to ensure that ATSS have the capacity to execute trades in a timely manner. Nevertheless, provided the Commission applies these requirements in a flexible manner that does not dictate how ATSS structure their operations, we would not oppose the SEC's proposal.

The Commission also would require ATSS to cooperate in SEC examinations, to keep certain records necessary to create a meaningful audit trail, and to make quarterly reports on the volume of trading in various categories. The Institute supports these proposals.

Finally, the proposals would require ATSS to implement procedures to protect trading information and, in particular, to keep ATS functions separate from other broker-dealer functions. The Institute agrees that the failure to keep trading information provided to an ATS

⁹ Proposing Release at 33, n. 89.

¹⁰ *Id.* at 46, n. 118.

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confidential creates the potential for abuse. Accordingly, we strongly support the Commission's proposal in this area.

V. Exemption for Pilot Trading Systems

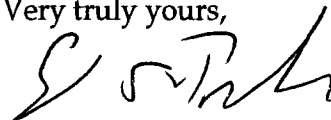
The Commission has proposed a rule under which securities exchanges could operate "pilot trading systems" without going through the rule filing process. A pilot trading system would be a system that did not exceed one of two alternative volume thresholds (depending on whether or not the system was operated independent of other trading systems operated by the same SRO). With respect to such a system, an exchange could simply make a notice filing with the Commission, and file quarterly reports thereafter. Information in the filings would be deemed confidential. Pilot trading systems would be required to meet certain minimum standards, and would have to file for permanent approval after two years, or within 60 days of exceeding the volume thresholds.

The Institute supports the proposed limited exemption for pilot trading systems, which may encourage further innovation. We would oppose, however, any expansion in the criteria for what would constitute a pilot trading system. In addition, we recommend that the Commission carefully monitor the operations of any such pilot trading system. If abuses or problems arise, the SEC should consider revising or repealing the rule.

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The Institute appreciates the opportunity to comment on these important proposals. Any questions may be directed to the undersigned.

Very truly yours,



Craig S. Tyle

cc: Richard R. Lindsey, Director
Division of Market Regulation

Barry P. Barbash, Director
Division of Investment Management

Securities and Exchange Commission