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Institute Comments on Proposal to Modify SOES and SelectNet Systems, June 1999

June 1, 1999

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

Re: Small Order Execution System and SelectNet Service (File No. SR-NASD-99-11);
Establishment of an Agency Quotation (File No. SR-NASD-99-09);
Limit Order Book Proposal (File No. SR-NASD-98-17)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposed rule changes filed by the National Association of Securities Dealers ("NASD"), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), to modify its Small Order Execution System ("SOES") and SelectNet system[2] and to permit the separate display of customer orders by market makers through a market maker agency identification symbol ("Agency Quote").[3] In addition, the Institute commends the Securities and Exchange Commission ("Commission") for reopening the comment period on Nasdaq's limit order book filing[4] and appreciates the opportunity to comment once again on the proposal.

As stated in our previous comment letter on the limit order book proposal,[5] the Institute strongly supports the proposal and urges its prompt adoption. The Institute believes the Agency Quote proposal would be less desirable than a limit order book. In addition, the Institute supports the proposed modifications to Nasdaq's SOES and SelectNet system.

I. General

As a general matter, the Institute believes that the proposals for an integrated SOES/SelectNet system and a limit order book—taken as a whole—would constitute a significant improvement to the quality of the Nasdaq market. The proposals logically follow, and would further the goals of, the Commission's efforts, beginning with the adoption of the Order Handling rules, to modernize the regulations that govern the Nasdaq stock market.

The Institute has strongly supported the Commission's efforts[6] and believes that they have made the Nasdaq market more open and fair. There are, however, steps the Commission could and should take that would build upon these market improvements—the most important of which would be to replace outmoded National Market System mechanisms with a system that provides investors with greater access to all priced orders and allows them to execute against those orders. A limit order book would accomplish these goals.

The Commission stated in the release proposing the SOES/SelectNet modifications that Nasdaq proposed these modifications, as well the Agency Quote proposal, as interim measures pending Commission action on the limit order book proposal. The release also states that both the SOES/SelectNet modifications and the Agency Quote proposal could significantly modify the existing Nasdaq market in ways that some may consider less desirable than the results of a proposed limit order book. The Institute cannot agree more with this statement.

The SOES/SelectNet proposal, taken alone, and the Agency Quote proposal fall short of addressing the market structure needs of investors. These proposals should not be viewed as interim measures pending Commission action on the limit order book. In order for improvements to be effectively made to the Nasdaq market, the limit order book should be promptly adopted in its proposed form.

Our specific comments are set forth below.

II. Limit Order Book Proposal

The Institute Strongly Supports A Nasdaq Limit Order Book

Under the limit order book proposal, a limit order book would be established which would provide market makers with a voluntary mechanism for the anonymous display of customer limit orders. These orders would then be fully viewable and accessible to all market participants.

The Institute strongly supports the limit order book proposal. A limit order book would for the first time provide an opportunity to centralize all institutional, retail, and market maker order flow. It thus would represent a crucial step in increasing transparency, increasing liquidity, and facilitating best execution in securities traded on the Nasdaq market. The limit order book also would help reduce market fragmentation by providing a central location for the placement of all customer limit orders. The Nasdaq market will only be made more efficient when all bids and offers in the same security can interact. The Institute therefore believes that investors, both institutional and retail, would benefit from the adoption of the limit order book.

A limit order book is especially important given the increased volatility in the Nasdaq market and the recent initiative to extend trading hours. Extending trading hours without the liquidity and transparency that would be provided by a limit order book could prove extremely detrimental to investors. The Institute therefore urges the Commission to permanently approve the limit order book without delay. [7] Investor protection has been and should continue to be the basis for Commission action in formulating market structure. Political pressures by those who oppose the limit order book should not be a factor in the decision whether to permanently adopt a limit order book.

The Agency Quote Proposal is not an Adequate Substitute for a Limit Order Book

Under Nasdaq's Agency Quote proposal, market makers in Nasdaq National Market ("NNM") securities would be permitted to display in the Nasdaq quote montage a second quotation separate from their proprietary quotation for the purpose of displaying customer orders in NNM securities. This second quotation could include the market maker's customers' orders and the orders of other broker/dealers.

Nasdaq states that it believes that the Agency Quote proposal should satisfy the interest of some market participants who desire to have a limit order book in Nasdaq, while addressing concerns that Nasdaq should not operate a limit order book that competes with members. In addition, Nasdaq states that because quotes will be more easily identifiable as either proprietary or agency, the proposal should also allow market participants to better identify the prices and sizes at which market makers wish to trade proprietarily. Nasdaq concludes that the proposal therefore should facilitate the negotiation of trades between market makers and institutions, as well as other market participants.

The Institute believes the Agency Quote proposal is not an adequate substitute for a Nasdaq limit order book. In particular, the agency quote proposal does not go far enough to improve transparency. The proposal would create a two tiered system with both agency quotes and proprietary quotes being shown in the Nasdaq quote montage for each market maker firm. The proposal therefore will effectively double the amount of quotes being seen by investors and will clutter the Nasdaq quote montage, especially for securities with a large number of market makers. This situation will further fragment the market and will make it more difficult for institutional investors to make a determination where to place an order.

The Agency Quote proposal is an attempt to respond to the concerns of certain market makers that they have "lost control" of their quotes because they now must either change their proprietary quotes to reflect customer orders or direct those orders to an ECN (or other broker/dealer). Whatever may be the merits of these concerns, they clearly do not outweigh the broader objective of increasing transparency in the Nasdaq market.

A Limit Order Book Should be Approved on a Permanent Basis

The Commission specifically requested comment on whether the limit order book proposal should be approved on a pilot basis. The Institute does not believe this is necessary. The Commission states that a pilot would provide experience with the limit order book and allow Nasdaq and the Commission to better gauge the impact of the book on the Nasdaq market. The Institute believes that over the past year since the limit order book was first proposed, Nasdaq has had sufficient time to discuss the potential impact of the limit order book with market participants. In addition, the limit order book has been the topic of numerous discussions within Nasdaq's Quality of Markets Committee, on which the undersigned and several Institute members participate.

Should the Commission, however, feel it necessary to approve a limit order book on a pilot basis, the Institute believes that the pilot should include securities representing a substantial portion of the trading market, e.g., 1000 securities, including the Nasdaq top 100 securities, with the remainder chosen from quintiles of NNM securities. Structuring a pilot program using a limited number of securities would effectively guarantee its failure from the beginning.

III. Integration of SOES/SelectNet Service

Under the proposed rule change, SelectNet would be re-established as a non-liability, order delivery and negotiation system for NNM securities. In addition, several changes would be made to SOES including: (1) increasing for NNM securities the maximum order size to 9,900 shares; (2) allowing market makers to enter proprietary orders into the new system and to obtain automatic execution for their proprietary and agency orders in NNM securities; (3) reducing the current 17-second delay between executions against the same market maker to 5 seconds; and (4) enabling NNM orders to interact automatically with market markers' displayed size and reserve size, including a market maker's agency quotes. Nasdaq also is proposing to eliminate the No Decrementation ("No Dec") feature for NNM securities, which currently allows continuous executions against a market maker’s quote at the same price without decrementing the quoted size, and the SOES preferencing feature for NNM securities as being inconsistent with the processing of orders in time priority as contemplated under the new execution system.

The Institute supports the proposed modifications to the SOES and SelectNet systems. The Institute believes that these modifications will increase the speed of executions and enhance access to the full depth of a security's trading interest by all market participants. In addition, the proposed modifications may increase a market maker’s ability to manage the receipt and execution of the ever increasing volume of orders experienced in the Nasdaq market.

The Institute wishes to emphasize, however, that the benefits to investors that would result from the integration of the SOES and SelectNet systems will truly be realized only if these changes are combined with a limit order book. Adopting the changes to SOES and SelectNet without a limit order book will not accomplish the Commission’s goals of modernizing and improving the Nasdaq market and will only necessitate further changes in the future.

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The Institute appreciates the opportunity to comment on these very important proposals.

Very truly yours,

Craig S. Tyle

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
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ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,576 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.860 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

[2] Securities Exchange Act Release No. 41296 (April 15, 1999), 64 FR 19844 (April 22, 1999).

[3] Securities Exchange Act Release No. 41128 (March 2, 1999), 64 FR 12198 (March 11, 1998). The Commission extended the comment period for this proposal until June 1, 1999. Securities Exchange Act Release No. 41243 (April 1, 1999), 64 FR 17428 (April 9, 1999).

[4] Securities Exchange Act Release No. 39718 (March 4, 1998), 63 FR 12124 (March 12, 1998).

[5] 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).

[6] See 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 ITS).

[7] The Institute also urges the Commission and the NASD to consider allowing trading to occur in the limit order file outside of normal trading hours. Many ECNs currently offer this capability and we believe this would be an attractive feature for the limit order book as well.