SEC Regulation NMS Hearing – April 21, 2004

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on behalf of the
Investment Company Institute

Good Morning. My name is John Wheeler. I am Vice President and Director of U.S. Equity Trading at American Century Investments. American Century Investments is an investment manager for institutional accounts and more than sixty retail mutual funds. We manage approximately $90 billion for 1.5 million investors.

I am testifying today on behalf of the Investment Company Institute, the national association of the American investment company industry, of which American Century is a member and which I am a member of the Institute's Equity Markets Advisory Committee. The Equity Markets Advisory Committee consists of approximately eighty traders at mutual fund firms and regularly comments on SEC and SRO rule proposals affecting institutional investors.

The Institute welcomes the opportunity to testify at today's hearing on proposed Regulation NMS and, specifically, on Regulation NMS' trade-through proposal. The Institute has strongly supported past regulatory efforts to improve the quality of the U.S. markets and commends the SEC for issuing proposed Regulation NMS, which is the latest example of these efforts. Because the Institute continues to examine many of the issues surrounding Regulation NMS, we will focus our testimony on those issues for which Institute members have reached a consensus.

Background

Before I comment on some of the specific issues relating to the trade-through proposal, I would like to take a minute to discuss why these issues are important to investors and, in particular, the mutual fund industry. The structure of the securities markets has a significant impact on the Institute's mutual fund members. Increased efficiencies in the markets will clearly benefit mutual fund shareholders. The Institute and its members, therefore, have a strong interest in ensuring that the securities markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the securities markets encourages, rather than impedes, liquidity, transparency, and price discovery.

Despite all the recent changes to the securities markets, the markets still do not facilitate efficient trading by mutual funds. Funds have been expressing concerns and recommending changes to certain aspects of the market structure for many years. For example, in the Institute's comment letter on the SEC's market fragmentation concept release in May 2000, the Institute raised concerns over the lack of priority rules for limit orders, inadequate market linkages, internalization, and the markets' lack of transparency and depth of book. The Institute also expressed concerns over the lack of protection for limit orders and the inability to interact with those orders in a March 2001 letter to the New York Stock Exchange and made several recommendations in order to facilitate trading by institutional investors on that market.

So how do we create the optimal market structure for investors? We believe the Commission must focus its efforts on the principles of a national market system that Congress found appropriate over thirty years ago for the protection of investors and the maintenance of a fair and orderly market - efficiency, competition, price transparency, and the direct interaction of investor orders. As the Regulation NMS proposing release itself notes, "perhaps the most serious weakness of the NMS is the relative inability of all investor buying and selling interest in a particular security to interact directly in a highly efficient manner. Little incentive is offered for the public display of customer orders – particularly the large orders of institutional investors. If orders are not displayed, it is difficult for buying and selling interest to meet efficiently. In addition, the lack of displayed depth diminishes the quality of public price discovery."

In order to provide investors with the incentive to publicly display their orders and to create a market structure in which these orders can effectively interact, the Institute believes that a market structure should contain several key components.

First, there should be price and time priority for displayed limit orders across all markets. Providing protection and priority for displayed limit orders would ensure that investors will realize the benefits of displaying those orders and thereby encourage further use of limit orders. As a result, the entire securities market would benefit from improved price discovery, liquidity, and tighter spreads.

Second, there should be strong linkages between markets that permit easy access to limit orders. Providing protection and priority for limit orders is not enough. An efficient market structure also must make these orders easily accessible to investors. Market linkages should not only be strong but should permit competition between markets and include systems that allow market participants to efficiently route orders to different markets on a price/time priority basis.

Finally, there should be standards relating to the execution of orders. In order for markets to function effectively, markets should provide the opportunity for fast, automated executions at the best available prices.

Trade-Through Proposal

I would like to turn now to some of the specific issues addressed in Regulation NMS' trade-through proposal.

The current debate over trade-through prohibitions is often framed as a dispute over what is more important for an investor when executing an order – obtaining the best price OR executing an order with speed and certainty of execution. The Institute believes that investors should not have to make this choice. Instead, investors deserve to have their orders executed under a market structure that provides immediate and certain execution at the best available price. Regulation NMS' trade-through proposal attempts to resolve this debate.

The Institute therefore supports the establishment of a uniform trade-through rule for all market centers. The proposal is a significant step forward in providing protection for limit orders and should, in turn, encourage investors to place limit orders into the securities markets.

At the same time, the Institute supports the exception to the trade-through proposal that permits an "automated" market to trade through a better priced displayed bid or offer on a "non-automated" market. Currently, the inefficiencies of the trade-through rule in the listed market, which in many instances forces orders to be routed to a non-automated market, makes it very difficult to execute large institutional orders in listed stocks. The Institute believes it is extremely important that the execution of orders entered into an automated market not be delayed by mandating that those orders be routed to a non-automated market where there is no guarantee that those orders will ever be executed.

However, while the Institute supports the distinction between an "automated" and "non-automated" market, we believe that the Commission should provide a stronger definition of what constitutes an "automated" market. Specifically, we believe that the Commission should establish a minimum performance standard with respect to response times and the time required to update or "refresh" a quote, such as, for example, under one second. In addition, we believe that in order to be considered an "automated" market, a market should be required to provide automatic execution to their entire limit order book and not only to their best bid and offer.

If the Commission strengthens its definition of an "automated" market in this manner, and creates strong linkages and access between automated markets, then we believe the proposal's other exception, the "opt-out" exception, may be unnecessary. The Institute does not believe that an ideal market structure should provide the ability for any market participant to ignore better priced orders in the market, especially if market participants can access and execute against the best price in the market, as well as prices inferior to the best price, automatically and with certainty. Although the Commission designed the opt-out exception to provide greater flexibility to informed traders, the exception is inconsistent with the principle of price protection for limit orders. We are therefore concerned that the exception could discourage the placement of limit orders if investors know that those orders can be ignored.

Let us be clear on one thing, however. If the Commission does not adopt a stronger definition of an "automated" market and permits disparities to remain in the ability to execute orders between "automated" markets under proposed Regulation NMS, we believe that the inefficiencies investors are experiencing in the markets today could remain. Under those circumstances, in order to allow investors to avoid having their orders routed to an inefficient market, an "opt-out" may be necessary.

In conclusion, the SEC will undoubtedly hear many different views today on what is the best market structure for investors from many different market participants, many of whom have self-interested positions due to the protection of their particular business model. The future structure of the US securities markets, however, should not, and cannot in the interests of investors, be structured in a manner to protect any such models. The opportunity is now for the SEC, the securities markets and all market participants, to create a market structure that truly benefits investors. We therefore urge the SEC to move expeditiously to implement changes to the structure of the markets and urge all market participants to work together in creating the most efficient market structure for investors.

Thank you again for giving the Institute the opportunity to share its thoughts on Regulation NMS and the trade-through proposal. I would be happy to answer any questions that you may have.