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September 27, 2000

Mr. Jonathan Katz
Secretary
United States Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: File No. S7-16-00

Dear Mr. Katz:

I. Executive Summary

The Island ECN, Inc. ("Island") appreciates the opportunity to comment on the Securities Exchange Commission's ("Commission's) Rule Proposal Regarding the Disclosure of Order Routing and Execution Practices ("Proposed Rule" or "Release").[1] Island applauds the Commission for seeking to address its concerns raised by internalization and payment for order flow by enhancing disclosure and fostering competition rather than by attempting to impose regulations dictating market outcomes. As stated in our response to the Fragmentation Concept Release,[2] Island strongly believes that the best way to address the Commission's concerns is to continue to remove barriers to competition. The most important remaining barrier is the Intermarket Trading System and the accompanying trade-through rule that prevents competition in the listed marketplace. Accordingly, Island urges the Commission to formally initiate rulemaking for a Trade-Through Disclosure rule in the equities market. With respect to the Commission's proposals regarding disclosure of order routing practices and execution quality statistics, Island believes that the Commission can achieve its objectives by: 1) creating a web-site with historical quote and trade information that allows investors to assess the quality of each execution; and, 2) requiring markets to make certain data publicly available.

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[1] Securities Exchange Act Release No.43084 (July 28, 2000).
[2] See The Island ECN, Inc. Comment Letter to File No. SR-NYSE-99-38 (May 12, 2000).

II. About Island

Island functions as a pure auction market - directly matching buy and sell orders. Island is the second largest ECN and now has almost 400 broker-dealer subscribers. Island was founded approximately three years ago with the intent of providing all market participants - from individual investors to large financial institutions - with the ability to execute transactions on a level playing field, at an extremely low cost without the presence of intermediaries or dealers. On an average day, Island trades over two hundred million shares, which is approximately 12 percent of the Nasdaq Stock Market Inc.'s ("Nasdaq") transaction volume.

III. Discussion

The most effective way for the Commission to address its concerns regarding the potential deleterious effects of internalization and payment for order flow is for the Commission to adopt regulations designed to increase competition. Increasing competition will reduce spreads, improve services, and improve the quality of executions received by retail investors without the need for the Commission to mandate certain order routing procedures. Although the Proposed rule seeks to increase competition through disclosure, Island believes that the Commission could have a far greater impact on competition by eliminating barriers to competition. The single largest barrier to competition that continues to exist today is the Intermarket Trading System ("ITS") trade through rule that applies to all participants in the listed market that are governed by the ITS Plan.

Although well intentioned, the indirect effect of the Trade-Through Rule is to inhibit competition by preventing each market from distinguishing themselves based on speed and quality of service. Island strongly believes that by expeditiously moving forward with the adoption of the Commission's Trade-Through Disclosure Rule for the equities marketplace, the Commission can make dramatic and historic progress toward achieving the goals of the National Market System. As the Commission noted in the Proposed Rule, one of the main goals of the National Market System is to "maintain the benefits of vigorous quote competition and innovative competition among market centers."

a. Competition and the Trade-Through Rule

Since the introduction of the Order Handling Rules that paved the way for ECNs to compete with traditional market centers, "quote competition and innovative competition among market centers" have exploded. With respect to quote competition, the Commission itself has noted that since the emergence of ECNs, investors have saved hundreds of millions of dollars from the resulting narrower spreads. Recent studies

reflect just how significant of a contribution ECNs have made to quote competition. One study found that "following implementation of the Order Handling Rules in 1997, the quotes of Instinet, an ECN, were on at least one side of the inside market 77% of the time, and the quotes of other ECNs were on a least one side of the inside market 70% of the time."[3] Another study similarly found that the ECNs are "important contributors to the price discovery process, being the dominant venue in eight of the ten most active stocks."[4] The same study also found that "ECNs submit more quotes to the Nasdaq market in the 30 most active stocks than all the traditional market makers combined" and that "ECNs have the smallest mean and median quoted spreads..."[5] What is striking about both these studies is that they are based on data more than 2 years old and thus, likely significantly <u>underestimate</u> ECN's current contribution to quote competition and price discovery.

While ECNs are unquestionably a leading source of quote competition in the Nasdaq market, ECNs have not made similar contributions to the listed marketplace. Due to regulatory barriers, ECNs are prevented from sharing their quotation information unless they sacrifice the very characteristics (i.e. speed and certainty of execution) that have made them successful on the Nasdaq market. Many market theorists believed that NYSE Rule 390 was the key barrier that precluded members from effecting transactions other than on an exchange. Since Rule 390 was abrogated, however, there has been no increase in competition in the listed market. Others believed that the barrier was the operation of the Nasdaq's ITS/CAES linkage.[6] Since the Commission approved Nasdaq's proposed rule changes, again there has been little impact.

b. <u>Trade-Through Rule – An Explanation</u>

As Island has long maintained, the key barrier to competition in the listed market is the existence of the ITS Trade-Through Rule. In its Proposing Release the Commission indicated that it was considering an alternative to the trade through rule based on disclosure. Specifically, as was proposed for the Options Market, a market center would be required to provide notice of trade-throughs to its customers.[7] Such a disclosure requirement would preserve the protections of the trade-through rule but remove the key barrier to competition. The best way to understand the anti-competitive effects of the trade-through rule and why the Commission should make Trade-Through Disclosure a formal rule proposal is to review the operation of the trade-through rule.

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[3] Michael J. Barclay, et al., *Effects of Market Reform on the Trading Costs and Depths of Nasdaq Stocks*, 54 J. Finance 1, 29-30 (Feb. 1999).
[4] See *Price Discovery by ECNs and Nasdaq Market Makers*, by Roger D. Huang, Owen School of Management, Vanderbilt University, Nashville, Tennessee (January 10, 1999).
[5] <u>Id.</u>
[6] Island has not participated in ITS/CAES for two main reasons: 1) the trade through rule discussed herein; and, 2) the inability of the ITS/CAES linkage to handle price improvement.
[7] Securities Exchange Act Release No. 43085 (July 28, 2000).

Example

Assume that the market in IBM is as follows:

	Bid	Offer
NYSE	60	60 1/8
Island	60	60 3/16

Further assume that Island Subscriber A, after carefully reviewing the Consolidated Quote, decides to send Island a limit order to buy at 60 3/16 despite the better advertised price at the NYSE. As a result of the trade-through rule, Island would be required to route the order to buy at 60 3/16 to the NYSE to obtain the better-advertised price despite Subscriber A's conscious decision to send the order to Island.[8] Under the ITS Plan, the NYSE would then have one minute to respond to Island's order and under some circumstances could even decline to trade at its advertised price.[9]

If, while the commitment to trade was awaiting disposition at the NYSE, Island Subscriber B routes an order to buy IBM at 60 3/16, Island is confronted with two bad alternatives. First, Island could delay the order (and thus all other executions) in IBM until it receives an "out" (either an execution or decline) from the NYSE. Unfortunately, this would reduce Island to operating at the speed of the NYSE and negate its advantages as an electronic marketplace. Second, Island could simply execute the order at 60 3/16. This alternative, however, negatively affects the integrity of Island's market. Specifically, if Island were to execute Subscriber B before Subscriber A, Subscriber B would have received an execution even though its order was received after Subscriber A's order.

c. The Trade-Through Rule – A "Real" Example

To further demonstrate how the trade-through rule inhibits competition, consider the following example of a recent, albeit common, occurrence on Nasdaq (which does not have not have a trade-through rule) where Island subscribers were forced to trade-through the best-advertised price. On September 7, 2000, a noted technology stock analyst added LanOptics (LNOP) to his recommended list. Upon the news, the market in LanOptics immediately began to surge. LanOptics opened at 19 ¾ Bid to 19 13/16 Offer. The price slowly moved up until approximately 10:08:19 when the market jumped from 23 9/16 Bid to 23 5/8 Offer to 27 15/16 Bid to 28 Offer in just two minutes. The trading activity during this two-minute time period provides the perfect case study for why the trade-through rule inhibits competition. During the entire two minute time period, the market on Island was 15-20 seconds ahead of the quoted market. For example, at 10:08:57, the

[8] Island could theoretically match the price offered by the NYSE but since Island does not trade as principal, this is not possible.

[9] This can occur, for example, when the security has already traded at the quoted price and the specialist is in the process of updating its quote.

NBBO in LanOptics was 24 15/16 Bid to 26 Offer. At the same time, Island effected multiple transactions at prices between 27.125 and 28.3125. The obvious question is why are Island subscribers 15-20 seconds ahead of the marketplace? The answer is critical to understanding why trade-throughs must be permitted.

A quick review of a few key Nasdaq rules offers some insight as to why Island subscribers traded through the quoted market. First, the Quote Rule has been interpreted as providing market makers with 17 seconds to update their quote following an execution. As a consequence, the NBBO at any given moment, especially when there is volatility, represents where the market was as many as 17 seconds ago. In addition, market makers may post a quote for as few as 100 shares. As a result, a market maker that was, for example, short a stock that was rising and needed to immediately buy back shares could hold the market down by slowly lifting his offer. The market maker's only obligation would be to execute 100 shares at each price level. In addition, other market participants are precluded from raising their bids above the slow market maker's offer or otherwise ignoring the slow market maker's quote because of Nasdaq rules prohibiting locked or crossed markets. As a result of these rules, oftentimes the NBBO does not reflect the true market on Nasdaq.

Given the regulatory structure, the answer becomes clear as to why Island was 15-20 seconds ahead of the market – Island is more efficient. While the market makers were trying to execute transactions and manage their positions, their quotations became stale. Perhaps some market participants wanted to slow the rise of the market and purposely did not update their quotes. Whatever the reason, the quotes did not accurately reflect the market. In fact, despite NASD rules prohibiting locked or crossed markets, the market in LanOptics was locked from 10:09:27 until 10:10:04.[10] Rather than attempt to access these stale quotes and incur the opportunity cost of waiting 30 seconds, Island subscribers traded on Island outside the quotes. Given that the market was locked and crossed, it appears that some market makers also believed that the quote did not reflect the actual market.[11]

In the LanOptics example, it is useful to consider what would have happened if there was a Nasdaq trade-through rule. Presumably, pursuant to a Nasdaq trade-through rule, Island would be required to send a SelectNet order to the market maker with the lowest offer. In light of the volatility in the market, it is unlikely that the Island subscriber would receive an execution. Given that Island subscribers have SelectNet access, the fact that they chose to ignore the better advertised price indicates that experience has taught them that the quoted market is irrelevant during times of volatility. If the Island subscribers were precluded from trading outside the quoted market, they would have been denied the opportunity to purchase the stock until it reached approximately $29. Such a result would have a chilling effect on price discovery and raise questions about the fairness of the market.

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[10] Island has long opposed NASD's prohibition on locked and crossed markets for many of the same reasons that it opposes the trade-through rule.

[11] It is a well-known fact that the automatic execution systems operated by wholesalers to interact with their retail order flow are turned off when the market is locked or crossed.

Island believes that most, if not all, market theoreticians would agree that it was reasonable and appropriate to trade-through the quoted market in the LanOptics example. The relatively inefficient market linkages in the listed market compared to Nasdaq indicates that there is a greater need to permit trade-throughs in the listed market. The LanOptics example reflects the potentially substantial opportunity costs incurred by investors if markets were prevented from operating efficiently.

d. Rationale For the Trade-Through Rule

As stated earlier, the purpose of the trade-through is to protect retail customers from receiving inferior executions on their market and marketable limit orders.[12] Island, however, believes that the obligation of best execution as well as good business practice already ensure a minimum execution quality for retail orders. Specifically, all market makers guarantee retail market orders an execution at the National Best Bid or Offer ("NBBO"). Furthermore, if the trade-through rule is an important tool for ensuring that retail orders do not receive executions outside the NBBO, one would expect to see more trade-throughs on Nasdaq, which does not have a trade-through rule, than on the NYSE. In fact, however, the Commission's Proposed Rule cites an SEC Office of Economic Analysis study that found that approximately 5.3% of small Nasdaq market orders (100-499 shares) are executed at prices outside the quotes at the time of order receipt. In comparison, an analysis performed by the NYSE staff indicated that approximately 7.5% of small NYSE market orders (100-499 shares) are executed outside the quotes at the time of order receipt. Even though this analysis compares the execution price to the NBBO at the time of order receipt rather than the time of execution, this finding strongly suggests that there is no material difference in the number of trade-throughs on each market despite the absence of a trade-through rule on Nasdaq.

The Commission's study indicates that retail customers would continue to receive executions at the NBBO even in the absence of a trade-through rule. Removing the prohibition against trade-throughs, however, will allow market participants that have the sophistication to control and monitor their own execution quality to trade at whatever price they deem acceptable. The removal of the trade-through rule would also allow the market to be more efficient during times of volatility as evidenced by the LanOptics example above.

Finally, in the Release, the Commission proposed providing disclosure to customers in instances where a trade-through occurs. While Island agrees with the concept of additional disclosure, the Commission should exempt certain types of customers. Specifically, the Commission should exempt from the definition of "customer," customers that direct their order to a specific market. Presumably, if an investor has the capability to direct the order to a specific market they are also aware of the quoted market at the time and do not need additional disclosure. Island also

[12] The other purpose of the trade-through rule is to protect displayed limit orders. Island believes, however, that if an order is truly accessible that market forces are sufficient to ensure it receives an execution.

recommends exempting institutions from the definition of "customer" since institutions may trade-through quite often due to the relatively large size of their trades. In addition, institutions typically possess the sophistication and means to monitor their own execution quality.

e. Disclosure of Order Routing and Execution Practices

In addition to requesting comment on a Trade-Through Disclosure rule for the listed market, the Commission proposed rules that "would require market centers to prepare and make available to the public monthly reports in electronic form that categorize their order executions."[13] The Proposed Rule attempts to measure certain aspects of execution quality. While the Commission's desire to increase the amount of information available to retail investors is laudable, Island believes that the measures included in the Proposed Rule do not measure execution quality. In fact, Island believes that it is impossible to quantify execution quality since it is by definition a subjective concept. Every market participant has a different definition of execution quality. Creating measures of execution quality presents many of the same challenges of quantum physics. Every time you measure one aspect, by definition you fail to measure another aspect and there is no measure that can capture all aspects.

Before discussing the specific measures proposed, Island also would like to briefly address one of the key assumptions that appears to underlie the Proposed Rule. Specifically, the Commission is concerned that since payment for order flow and internalization allow some market centers to receive order flow regardless of their quoted market, building pressure to eliminate such practices will lead to more competitive markets.[14] Island believes that even if the Commission were to eliminate such practices, however, that there would be no material impact on spreads. Market makers and specialists cannot consistently quote aggressively because it is not in their economic self-interest. No amount of regulatory pressure can make market participants engage in market activities that are not in their economic self-interest. Market makers simply cannot offer guarantees of an execution at the inside market, that they currently only offer to retail order flow, to the entire marketplace. For this reason, Island believes that the prime source of future quote competition will continue to come from ECNs.

1. Statistical Measures

Island is concerned that the various proposed measures of execution quality fail to accurately measure the quality of a market and also fail to take into account the business model of ECNs. For instance, one measure that seems to be particularly important to the Commission is price improvement.[15] Island, in contrast to many in the industry, has long maintained that price improvement is not a measure of execution quality. If a market was

[13] Securities Exchange Act Release No. 43084 at p.12 (Internet version)

[14] For instance, the Commission states "these passive, "price-matching" business strategies employed by dealers may weaken the incentive to display competitive quotes and blunt the forces that otherwise could lead to less fragmented markets," Page 7

[15] Securities Exchange Act Release No. 43084 at p.18 (Internet version)

truly fair and efficient, price improvement would never occur because every order would be reflected in the quote. Thus, price improvement statistics reward the least fair and efficient markets that fail to reflect true trading interest in the quote. An exchange specialist or a market-maker has the opportunity to interact with all incoming orders as principal. Thus, if such a market professional wants to be long the stock, for example, it can price improve an incoming order without ever reflecting its own trading interest in the quoted market. The use of this unique time and place advantage would appear as price improvement in the Commission's statistics. In addition, when an exchange specialist or market maker price improve the incoming order, on many occasions they do so at the expense of a customer limit order that would have otherwise been executed. In contrast, Island represents orders immediately, thus establishing a new inside market. By definition, therefore, that order cannot be the source of price improvement even though it narrowed the inside market.

Another weakness of price improvement statistics is that they do not take into account pure agency markets that immediately display all of their orders. In pure agency markets, price improvement is a zero-sum game. If one market participant is receiving price improvement then, by definition, the other side of the trade is receiving price dis-improvement. The only two exceptions to this rule on Island are executions that occur inside the spread due to finer increments and orders that are entered as "non-displayed." Island does not believe, however, that it should be rewarded statistically for either type of price improvement.

Island is also concerned that many of the measures are biased toward market orders. Price improvement, for example, is traditionally associated with market orders. The Commission repeatedly discusses the importance of assessing the executions of market orders in relation to the NBBO at the time of receipt and execution. Island, however, only accepts limit orders. As a result, subscribers only receive their order entry price or better. In addition, Island subscribers oftentimes enter limit orders that are outside the NBBO. This is done because, as discussed in detail earlier in the LanOptics example, the NBBO often does not reflect the actual market in a security. Thus, all the executions in the LanOptics example, considered to be among the best executions available on Island, would appear in the statistics as "bad" executions. In fact, given that the NBBO does not always reflect the actual market makes all the statistics generated based on the NBBO suspect.

Island believes that the "fill rates" statistic is also problematic.[16] Fill rates are intended to measure the likelihood that a limit order will be executed if displayed at a particular market center. Fill rates, however, are highly dependent upon the type of orders received by a market. Recipients of retail order flow will always have the highest fill rates since the limit orders are most likely to be mis-priced in relation to the market. In addition, market professionals are more likely to execute against retail order flow since it is regarded as uninformed. This is evidenced by the fact that market makers only guarantee an automatic execution at the inside market for market orders to retail customers. No market maker would extend such a guarantee to an "informed" trader. In

[16] Securities Exchange Act Release No. 43084 at p.17 (Internet version)

contrast, Island has many sophisticated subscribers that enter orders that they may cancel and replace multiple times prior to receiving an execution because they are more price sensitive than a retail customer. This practice would reduce Island's fill rate since the statistics do not subtract out cancelled orders.

The most unusual statistic is the "average realized spread."[17] While it is difficult to even respond to how useful this measure is, it appears to be an attempt to measure adverse selection in a market. As with many of the proposed statistics, this fails to take into account that in an agency market that the average realized spread would be zero since there are two sides to every trade.

2. Another Approach

Island has raised only a few of what appears to be a limitless number of conceptual weaknesses with any of the proposed statistics. Another market participant with a different business model could likely raise many other inconsistencies. As stated above, Island believes that it is impossible to measure execution quality and, therefore, the Commission will never find a statistical measure that does not have conceptual weaknesses. Rather than impose what will likely be a rather burdensome reporting regime, the Commission should simplify the proposal. To address its concerns about the lack of execution quality information available to investors, the Commission could require the creation of a free web site where investors could assess their execution quality on a trade-by-trade basis. By using their time of execution, investors could compare their trade price to other trades and quotes during the same time period. To simplify the process for investors, brokers could provide their customers with an identification number that the customer could enter into the site to locate their order. The web site could be jointly run by the securities information processor for each primary market (e.g. Nasdaq and SIAC) and the information could be provided on a next day or delayed basis.

To address the Commission's desire to increase the amount of information available concerning execution quality, market centers could be required to make information available to interested parties for analysis. These interested parties could then tailor their statistical analysis based on the priorities of the segment of the market they are attempting to serve. For instance, execution quality analysis companies would perform a different kind of analysis for institutions than a retail broker gathering best execution information. On a periodic basis, perhaps quarterly, market centers could be required to make their order data information publicly available in a standard format. By not requiring any specific statistical measures, the Commission would leave it to the marketplace to determine the best measures of execution quality.

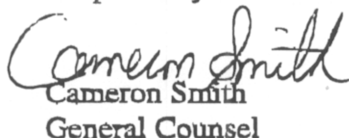
IV. Conclusion

Island agrees with the Commission's goal of increasing competition and providing more information to investors. While additional information concerning

[17] Id.

execution quality would be helpful to investors and market participants, the only way to ensure a truly competitive marketplace is to remove barriers to competition. Island strongly believes that the ITS trade-through rule is one of the last remaining barriers. Upon its removal, and in combination with decimalization, the Commission will witness a reduction is spreads in the listed market that should address many of its concerns outlined in the Proposed Rule and the Fragmentation Release.

Respectfully Submitted,



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