

SEC Regulation NMS Hearing - April 21, 2004

Summary of Intended Testimony

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American Century Investments
on behalf of the
Investment Company Institute**

The Investment Company Institute, represented by Mr. John J. Wheeler, Vice President and Director of U.S. Equity Trading, American Century Investments, welcomes the opportunity to testify at the SEC's hearing on proposed Regulation NMS. The Institute intends to focus its testimony on the issues raised by the proposal that could have the most significant impact on investors. In addition, because the Institute is still examining many of the complex issues addressed by proposed Regulation NMS, we will focus our testimony on those issues on which our membership has reached a consensus.

Background

The structure of the securities markets has a significant impact on our mutual fund members, who have over \$7 trillion of assets under management on behalf of over 86 million individual shareholders. The Institute and its members, therefore, have a keen 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. Consistent with these goals, we have strongly supported past regulatory efforts to improve the quality of the U.S. markets. The Institute commends the Commission for issuing proposed Regulation NMS, which is the latest example of these efforts.

We are pleased that proposed Regulation NMS addresses how to best further the objectives of the national market system that are so critical for investors (*i.e.*, efficiency, competition, price transparency, and the direct interaction of investor orders). As the Regulation NMS proposing release states, "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 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. Our members report that without adequate protections for limit orders, they often are reluctant to place these orders for fear that they will go unexecuted while at the same time they are used as a basis for other investors to trade against.

- *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.
- *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. Minimum standards relating to the execution of orders would ensure that slower, inefficient markets do not inhibit faster, more technologically advanced markets in the execution of investor orders.

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, they deserve to have their orders executed under a market structure that provides immediate and certain execution at the best available price. Proposed Regulation NMS' trade-through proposal attempts to resolve this debate. Our initial comments on the trade-through proposal follow.

- *We support the establishment of a uniform trade-through rule for all market centers.* The proposed trade-through rule would prevent the execution of an order for national market system stocks at a price that is inferior to the best bid or offer displayed by another market center at the time of execution. 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. (We note, however, that while the proposed trade-through rule would affirm the principle of price priority, the proposal would still not address the issue of time priority for limit orders.)
- *We support the exception to the trade-through proposal that permits an “automated” market to trade through a better displayed bid or offer on a “non-automated” market.* Our members report that the inefficiencies of the current 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 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.

- 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 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. In addition, the Commission should establish a minimum performance standard with respect to response times in order to better define what is considered an “immediate” response, *e.g.*, all executions must take place in under one second.
- *If the Commission strengthens its definition of an “automated” market and creates strong linkages and access between automated markets, then the proposal’s “opt-out” exception may be unnecessary.* The Institute believes that an investor who can access and execute against the best price in the market, as well as prices inferior to the best price, automatically and with certainty would have no need to affirmatively opt out from receiving the best price. 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 concerned that the exception could discourage the placement of limit orders if investors know that those orders can be ignored.
- *If, however, the Commission adopts the definition of an “automated” market as proposed (i.e., requiring automation only at the best bid and offer and with no minimum standards for the execution of orders), then an “opt-out” exception may be necessary.* Although 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, we are concerned that if disparities remain in the ability to execute orders between “automated” markets under proposed Regulation NMS, the inefficiencies investors are experiencing in the markets today will 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.

Market Access Proposal

The Institute is still examining the details of proposed Regulation NMS’ market access proposal and its impact on investors. In general, however, the Institute supports the modernization of the terms of access to quotations and the execution of orders in the national market system. The Institute believes that ensuring that investors have non-discriminatory access to the best prices for a security, no matter where they are displayed in the national market system, is extremely important to the overall structure of the markets.

In addition, the Institute believes that prior to implementing an effective trade-through rule, the Commission must ensure that effective linkages between markets and strong access rules are in place. We are still examining the most effective methods for providing such linkages and access, specifically whether they can be provided through “hard-wired” linkages or through required minimum access standards.

Sub-Penny Quoting Proposal

The Institute strongly supports the SEC's proposal to prohibit sub-penny quoting in most stocks. The proposal would address many of the concerns expressed by investors about quoting securities in increments of less than one penny, specifically: increased instances of "stepping-ahead" of customer limit orders, which could create a significant disincentive for market participants to enter any sizeable volume into the markets; increased instances of "flickering" quotes; and the reduction in market transparency and depth, which can adversely affect institutional investors' ability to execute large orders.

Market Data Proposal

The Institute is still examining proposed Regulation NMS' market data proposal. In general, we believe that the issues raised by the market data proposal are very important to the effective functioning of the markets. Reliable and timely market information is an important means of enhancing the transparency of the buying and selling interest in a security, for addressing the fragmentation of buying and selling interest among different market centers, and for facilitating the best execution of customers' orders by their broker-dealers.