April 28, 2000

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

Re: File No. SR-NYSE-99-48; Release No. 34-42450; Market Structure

Dear Mr. Katz:

The International Securities Exchange LLC ("ISE") is pleased to respond to the Commission's request for comment on market fragmentation (the "Fragmentation Release").[1] We have drafted our comments in the form of the attached "production notes" for an *imaginary* market structure version of the television show "Who Wants to be a Millionaire."

As we make clear in the attachment, we believe that the United States has the world's fairest, most efficient and most competitive securities markets. We urge the Commission to build upon this foundation by encouraging evolutionary and incremental changes in the market, such as by enhancing transparency and encouraging the development of ways to protect customer limit orders across markets.

We recognize that some market participants are asking the Commission to discard the sound foundation on which our markets are built, and to take an active and unparalleled role in reshaping our capital markets into a central "consolidated limit order book" ("CLOB") or similar system based on price/time priority. We strongly urge the Commission to resist that request. Indeed, we fail to understand the basis for arguing that the world's premier securities markets should become a laboratory test for an unproven attempt at government control of the private market. Commission action requiring the development of a CLOB, or any other specific market structure, would be directly contrary to (1) Congress' mandate in the Securities Exchange Act of 1934 ("Exchange Act") instructing the Commission only to "facilitate" development of the national market system ("NMS"), (2) the Commission's history in implementing that mandate, and (3) the historical reluctance of the government to intervene in the private sector.

[1] While the Commission's release requested comments both on market fragmentation and the proposal of the New York Stock Exchange, Inc. ("NYSE") to repeal its Rule 390, our comments will address only fragmentation. We take no position on Rule 390.

If you have any questions on our letter, of if we can be of further help to the Commission on this issue, please do not hesitate to call us.[2]

Yours very truly,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth
Robert L.D. Colby

Attachment

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[2] We also request that the Commission include in this file the recent comment letter we submitted to the Commission regarding the development of an intermarket options linkage. Letter dated April 3, 2000 from Michael Simon, Secretary, ISE, to Jonathan G. Katz, Secretary, Commission. File No. 4-429. The issues the Commission is considering with respect to an options linkage are closely related to the issues relating to fragmentation.

Production Notes for the Market Structure Version of

Who Wants to be a Millionaire

Rules of the game: A contestant answers up to 15 questions of increasing difficulty for increasing amounts of money. If the contestant answers all 15 questions correctly, he or she wins $1,000,000. If the contestant wins $1,000, the contestant is guaranteed that amount of money, even if he or she misses a later question. The same is true at the $32,000 level. At any point in the game prior to giving a final answer to a question, a contestant can end the game and keep the money won to that point. A contestant also has three "lifelines" that he or she can use one time each in the game: polling the audience; calling a friend for advice; and randomly eliminating two of the four possible answers.

Question 1: $100

Question: What country has the fairest, most efficient securities markets?

Choices:
a. Germany
b. United Kingdom
c. United States
d. Texas

Notes for Regis: Any person with even a passing knowledge of the market knows that the United States has the world's premier securities markets, particularly for individual investors. It is this reputation that attracts the most liquidity to the U.S. markets, which, in turn, provides even greater benefits for investors.

Correct choice: c.

Question 2: $200

Question: The general focus of securities regulation in the United States is on the protection of which of the following groups?

Choices:
a. Broker-Dealers
b. Exchanges
c. Lawyers
d. Investors

Notes for Regis: The law makes clear that that the SEC must focus on protecting the interests of investors both when considering regulatory action and when reviewing proposals of the so-called self-regulatory organizations (or "SROs"). Numerous sections of the Exchange Act, such as Section 6(b)(5), 11A(a)(1)(C), and 15A(b)(6) contain this mandate. Indeed, this is the very reason why the United States has the world's premier securities markets.

Correct choice: d.

Question 3: $300

Question: The SEC's role in the development of the NMS is which of the following?

Choices:
a. Dictating the development
b. Facilitating the development
c. Impeding the development
d. Ignoring the development

Notes for Regis: OK, now the questions get a bit more difficult. The contestant easily can eliminate the last two, and then should realize that the government of the United States rarely "dictates" anything about private industry. As to the governing law, Section 11A(a)(2) of the Exchange Act clearly sets forth the SEC's role in developing the NMS as "facilitating" the development. While most market participants acknowledge this concept, some conveniently "forget" the limitations inherent in a "facilitation" role (if such forgetfulness would advance their own interests). Hopefully, the contestant will appreciate that the SEC neither should impose on the securities industry its view of market structure nor mandate radical changes to market structure (unless there is some colossal market failure). Rather, the SEC should encourage incremental steps to improve a basically sound market. Unless the contestant recognizes this, he or she will not proceed far in this contest.

Correct choice: b.

Question 4: $500

Question: Which of the following did Congress *not* find to be a cornerstone in developing fair and orderly markets and an NMS?

Choices:
a. Fair competition between markets
b. Best execution of customer orders
c. Enhanced market information
d. Consolidation of markets

Notes for Regis: While this is the first question that really starts to test market structure knowledge, a contestant still can bluff his or her way through this one. The first three answers are obviously correct . This is all outlined in Section

11A(a)(1)(C) of the Exchange Act. In addition, with even a passing knowledge of market structure and competition, the contestant should know that consolidating multiple competitive markets into a single market makes no sense and only can lessen competition.

Correct choice: d.

Question 5: $1000

Question: There is a substantial body of knowledge indicating that fragmentation has which of the following effects on the U.S. securities markets.

Choices:

a. Fragmentation is a big problem requiring the restructuring of markets
b. Fragmentation is not a problem at all
c. Fragmentation is the strength of U.S. markets
d. There is no substantial body of knowledge on the subject

Notes for Regis: It is clear from the Fragmentation Release that there is no significant knowledge on the subject. What may confuse the contestant is that the SEC is asking for comment on whether it should take radical steps to change our markets without evidence that there is a problem here. We assume that the main purpose of the release is to help determine whether, in fact, fragmentation is a problem. It obviously would be premature to take some of the more radical steps discussed in the release until there is some consensus that a fragmentation "problem" actually exits.

Correct choice: d. If answered correctly, remind the contestant that the $1,000 is his or hers to keep, even if he or she answers a subsequent question incorrectly.

Question 6: $2000

Question: In what industry has the U.S. government mandated that customers only buy from the first company to post the best price?

Choices:

a. Airlines
b. Consumer electronics
c. Prescription drugs
d. None of the above

Notes for Regis: Just when the contestant thinks a hard question is coming, we toss out an easy one! You don't even have to use any of that "Is that your final

answer?" schtick. A knowledgeable contestant knows that no government anywhere in this country has ever mandated that a customer buy strictly on a price/time basis. The purpose of this question is to set the stage for a series of questions on price/time priority that really will test the contestant.

Correct choice: d.

Question 7: $4,000

Question: In what document has the SEC or its staff rejected strict price/time priority as the basis for the national market system?

Choices:
a. January 1978 Statement on a National Market System
b. March 1979 Progress Report on a National Market System
c. 1994 "Market 2000" Report
d. All of the above

Notes for Regis: The purpose of this question is to demonstrate that the SEC consistently has rejected price/time priority as the foundation for the national market system. The SEC did so in its January 1978 statement on a national market system (Exchange Act Release No. 14416 (January 26, 1978)) and in its follow-up report in 1979 (Exchange Act Release No. 15671 (March 22, 1979)). The staff reiterated that point in its Market 2000 Report in 1994. The continuing theme is that price/time and, its cousin, the CLOB, are inherently anticompetitive in that they focus competition on a sole factor: the first market to display a price. The SEC never has elevated one form of competition to be the sole basis on which markets should compete.

Correct choice: d.

Question 8: $8,000

Question: What terms has the SEC or its staff used to describe strict price/time priority?

Choices:
a. Radical
b. Potentially disruptive
c. Potentially stifling innovation and competition
d. All of the above

Notes for Regis: The SEC has used all these terms in the three releases noted in the answer to Question 7, above. Indeed, Chairman Levitt, in his March 2000

speech at Northwestern University School of Law, Kellogg Graduate School of Management, articulately restated this view:

> Of course, if we had a single, monolithic market, fulfilling [a broker-dealer's best execution] responsibility to customers would be much simpler. But, I believe Congress was visionary in choosing not to mandate such a market. Over the last 25 years, our system of competing market centers has been the driving force behind faster and cheaper executions, spawning new trading systems that provide anonymity and greater liquidity.

Other commentators recently have used even stronger language in outlining concerns regarding a CLOB. Specifically, the NYSE recently issued a "Market Structure Report" prepared by a special committee of its non-industry Board of Director members. These directors noted that even the most ardent supporters of a CLOB recognize that there will be many types of orders that would require special handling outside of a CLOB, particularly larger orders. By removing larger orders from a CLOB, the directors noted that the market actually would become *more* fragmented, *less* liquid and *less* transparent. On page 30 of that report, the committee noted that the CLOB proposal seemed to be self-serving in that it "would confer advantages on certain business modes and not others." They further suggest "that what large-firm CLOB proponents are after is simply a stream of pricing data generated from the interaction of retail order flow; the thesis is that the CLOB advocates will then use this information to price large block trades off of the CLOB, in a less transparent environment."

Correct choice: d.

Question 9: $16,000

Question: In its Market 2000 Report, what event did the SEC staff suggest may be an appropriate trigger for the SEC to consider strict price/time priority for the securities markets?

Choices:

a. A significant market failure
b. A joint proposal by large broker-dealers
c. The development of technology capable of accomplishing this
d. A total solar eclipse

Notes for Regis: This does not require intimate knowledge of the staff's report. While the SEC certainly will consider the thoughts of a few large broker-dealers, that alone clearly is not sufficient to warrant a 180 degree shift in public policy. Either a or c seem reasonable. A lifeline may be appropriate here and the contestant may ask to poll the audience. Your knowledgeable audience will

know that technology to route orders based on price/time priority has existed for quite a while. When properly analyzed, the contestant should recognize that the government intervenes in the market only when there is a significant failure of market forces.

Correct choice: a.

Question 10: $32,000

Question: What has changed in the securities market since the various times that the SEC and its staff have rejected strict price/time priority?

Choices:
a. A significant market failure
b. A failure of free market competitive forces
c. A change in the Congressional mandate
d. None of the above

Notes for Regis: It is a basic fact that Congress has not amended Section 11A of the Exchange Act regarding the NMS since the adoption of that section in 1975. Thus, c is wrong. As to the first two answers, if anything, the U.S. markets are in the midst of a period of extraordinary growth and vitality. While the SEC has "tweaked" the markets through such efforts as the order handling rules and Regulation ATS, there has been no need for a major change in government regulatory policy. Especially since the Market 2000 Report in 1994, there has not been a market failure of any type.

Correct choice: d. The contestant now enters dangerous territory. The $32,000 is his or hers to keep, but if a contestant gives a wrong answer from here on in, their total winnings reverts back to $32,000. Remind the contestant they always can bail out before giving a "final answer" to the remaining questions, keeping what they have won up to that point.

Question 11: $64,000

Question: Which of the following accurately describes the legal ability of non-SROs to directly join NMS plans?

Choices:
a. Fully able to join
b. Precluded by SEC rules from joining
c. Precluded by law from joining
d. Need NYSE approval to join

Notes for Regis: This is a tough one. A contestant that has progressed to this level may know that the answer lies in Section 11A(a)(3)(B), where Congress authorizes the SEC, by rule or order, "to authorize or require *self-regulatory organizations* to act jointly" on NMS matters (with our emphasis). What may confuse the contestant is the often-made suggestion to allow so-called alternative trading systems or "ATS's" to join NMS plans directly. Congress specifically limited NMS plans to SROs due to the status of SROs in the regulatory "ladder." The SEC sits atop this ladder, with SROs one rung below. This is because SROs are the most highly regulated members of the securities industry, with responsibility for regulating their members and operating fair and orderly markets. Broker-dealers come next, focusing on the handling and execution of customer orders. Thus, it makes the most policy sense for SROs to be the direct participants in the plans, with their members participating through the SRO vehicle. The SEC recently approved exactly that sort of arrangement regarding ATS's and the Intermarket Trading System. (Exchange Act Release No. 34-42536 (March 16, 2000).) Allowing direct entry of ATS's and others into NMS plans would require another layer of regulatory oversight since it would be highly inappropriate for non-SRO's, who do not have regulatory authority or responsibility, to police their own activities in an NMS facility.

Correct choice: c.

Question 12: $125,000

Question: What effect will the repeal of NYSE Rule 390 likely have on fragmentation in the securities markets?

Choices:
a. Might increase fragmentation
b. Might decrease fragmentation
c. Could redefine the nature of fragmentation
d. None of the above

Notes for Regis: Serious students of the securities markets know that Rule 390 has little effect. It has never applied to pure agency trades, only principal orders and agency crosses. Also, all stocks listed after 1979 (now the great majority of NYSE stocks) are totally exempt from the rule. Even for those stocks subject to the rule, an NYSE member firm can "internalize" today in a variety of ways that could "fragment" the market, such as by setting up a specialist operation on a regional exchange, preferencing through the Cincinnati Stock Exchange or trading overseas. The most likely effect of the repeal of Rule 390 would be to *reduce* fragmentation by consolidating all those ways around Rule 390 into the third market. Indeed, we may be on the verge of an upcoming *consolidation* of markets, not increased fragmentation. The pending merger of the Pacific

Exchange's equity business with Archipelago seems likely to be the first step in what will be combinations of competing markets to create liquid pools of trading.

In a sense, it almost seems like 1975 again. That is the year that Congress first adopted the NMS legislation to deal with the then-fragmented markets. However, fragmentation at that time was due to the artificial regulatory barrier of fixed commissions, which were driving market participants to alternative markets. When the SEC abolished fixed commissions, fragmentation actually *decreased*. It is likely that will occur again once Rule 390 dies: broker-dealers will consolidate trading in the most attractive markets, not trade in markets that are attractive only as regulatory escapes. Moreover, broker-dealers that never joined a primary exchange to avoid Rule 390 may actually join such exchanges and send order flow there, further decreasing fragmentation.

Correct choice: b.

Question 13: $250,000

Question: One SEC proposal is a requirement that broker-dealers expose, as improved quotations, customer orders of all sizes for possible price improvement before trading against such orders as principal (unless the customer requests otherwise). Which of the following best describes the most likely effect of that proposal?

Choices:
a. It would provide significant price improvement for customers
b. It would increase liquidity in the market
c. It is impractical and would clog up a system already strained for capacity
d. It would divert trading to unregulated overseas markets

Notes for Regis: One can argue that all four effects are possible, and maybe even likely. However, the question is what is *most* likely. This is a good candidate for the lifeline of removing two answers. The two that would be removed (randomly, of course) are b and d. Answer b is wrong because exposing an order really doesn't add liquidity, the order already exists in the market. Also, assuming there is an "out" allowing customers to choose not to have their orders displayed, it likely will not result in the loss of order flow to unregulated markets, eliminating d. That leaves a and c. It is possible that there may be some price improvement for customers. However, it is unclear how much price improvement there would be with lots of small orders flashing as improved quotations. We also assume that the effect of the rule would be that mainly small orders would be exposed – institutions entering larger orders may well request that their orders *not* be displayed, since their focus would be on achieving a speedy execution of their orders in full, rather than broadcasting their trading intentions to the world.

The more likely effect of requiring a market to expose small orders as improved quotes is that it would add tremendous quotation traffic to already-overburdened systems. This quotation overload already has caused the National Association of Securities Dealers, Inc. to postpone the introduction of decimalization and is creating havoc in the options markets. Also, any significant price improvement becomes even less likely if the minimum pricing variation falls to a penny. Indeed, such a display requirement could lead to more internalization, as firms "expose" orders at a penny-better price and then trade against them.

Correct choice: c.

Question 14: $500,000

Question: If the SEC were to limit a price/time mandate to orders or quotes that better the national best bid or offer, what effect would that have on the NMS?

Choices:

a. It would better the NMS and address virtually all the concerns critics have raised about price/time priority
b. It would address some NMS concerns, but still have major adverse effects
c. It would be worse than total price/time priority
d. All of the above

Notes for Regis: This complex question is based on alternative "e" the SEC raised for comment in the Fragmentation Release. "D" cannot be right because the answers are mutually exclusive. Weighing the other three answers, this limited form of price/time priority clearly seems less of a problem than full-blown price/time priority: it would address at least some price/time problems, such as ensuring that an order does not receive priority only because it was the "first to fade" to a price, and other markets then fade to join it. Since it clearly isn't worse than total price/time priority, answer c is wrong. The question then boils down to the degree to which limiting price/time priority in this manner address the overall concerns with price/time priority. The contestant should recognize that even this limited form of price/time priority still would elevate one form of competition above all else. Efficiency, fee-based competition, size-based competition, and open access all would have marginal relevance. Even limited price/time priority would add needless complexity to the market system and would inappropriately reward trading interest that might arrive in the market a nano-second ahead of other trading interest. Thus, any type of price/time priority has major problems, and the costs of the system would outweigh any potential benefits.

Correct choice: b.

Question 15: $1,000,000

Question: Which of the SEC's proposals to address fragmentation should be the cornerstone of its regulatory policy moving forward?

Choices:
a. Imposing some form of price/time priority system
b. Requiring greater disclosure of order routing and execution information
c. Restricting or prohibiting internalization and payment for order flow
d. Protecting displayed customer limit orders

Notes for Regis: This is really the $1 million question and we assume that a contestant making it this far will use his or her third lifeline to call a friend. Hopefully that friend has market structure experience and can help the contestant reason through the possible answers. The four choices represent various scenarios on which the SEC requested comment in the Fragmentation Release. One possible scenario – requiring exposure of customer orders – already has been rejected as a possible cornerstone of regulatory policy in question 13 (it would impose significant costs on the industry, without much benefit). The two scenarios involving price/time priority have been collapsed into answer a, and obviously are wrong for the many reasons discussed in the analysis of previous questions. That leaves three possible answers. Addressing each of these:

- *Disclosure*: Because disclosure has worked so well both in public offerings and in continuing reporting for public companies, the SEC has the natural urge to apply disclosure in other contexts. Disclosure generally is a preferred regulatory approach since it does not impose substantive requirements on market participants. (Something about sunshine being a good disinfectant.) However, disclosure is a viable choice only where it would accomplish something. Unfortunately, there is little reason to believe that disclosure works in the market structure world. The problem with disclosure is that virtually no one pays any attention to what is disclosed. Nevertheless, this works for corporate matters, where a relatively few analysts can pore over obscure data, compare companies, and make recommendations to investors. This leads to efficient pricing. Also, the very discipline of having to file disclosure documents forces a level of discipline on corporate conduct. This is not the case when broker-dealers disclose their order-routing practices to customers. Indeed, one look at a standard confirmation shows that this "disclosure" is little more than a body of fine print that many investors ignore. There are no analysts reviewing these documents to translate the disclosure into useful market place information. Even if the SEC required this disclosure to be in "plain English," there still is little reason to believe that the disclosure would be meaningful to investors and that they would choose broker-dealers based on this information. Unfortunately, assuming fragmentation is a "disease," disclosure is not the cure.

- *Internalization/Payment for Order Flow*: The contestant may think this is the right answer, given the nefarious reputation of these practices. However, while internalization and payment for order flow give rise to concerns, the root of the problem is not related to market structure. Rather, it is that these practices "muddy" the best execution waters by creating incentives for broker-dealers to send customer orders to markets that may not provide best execution. Thus, the SEC appropriately is addressing these concerns in the context of best execution. If the SEC ultimately decides that these practices cannot be policed through best execution, the best approach would simply be to ban them. However, while these practices give rise to significant concerns, simply banning them cannot be the cornerstone of a regulatory policy.

- *Limit order protection*: When the contestant thinks about this, perhaps after losing a lot of money, he or she will realize that the first two questions in this session really provide the answer here: we have the best markets in this country because the focus is on protecting investors. In our current market environment, the best way to help investors is by protecting their limit orders. The SEC already requires display of these orders. The next step is to protect them against other markets "stepping up" to trade at the price of a limit order without satisfying the order. There already is precedent in this area in the "trade through" rule, which protects customers against executions at prices inferior to their orders. Obviously, this is an area that requires much more thought, and not an immediate government dictate specifying all the details of a solution. What would make the most sense is for the SEC to instruct the markets to work together and develop one or more approaches to protect customer limit orders. In so doing, the SEC must take care to ensure that the markets remain viable competitors. This means that there must be careful consideration of ways to allow exchanges to quote aggressively for order flow, such as allowing exchanges to trade at any prices they are disseminating, as long as those prices are firm for all incoming orders. This provides liquidity. The problem arises only when markets "step up" to trade at a price that matches another market, and is not holding itself out as willing to trade at that price. These are issues the markets themselves are best able to address, with the government carefully looking over their shoulders.

Correct choice: d. Any contestant making it this far deserves not only the $1 million price, but your hearty congratulations for being a real market structure maven!