June 1, 1998

Mr. Jonathan Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. SR-NASD-98-17

Dear Mr. Katz:

This comment letter is written in response to the Nasdaq’s recent proposed rule change relating to an Integrated Order Delivery and Execution System (Release No. 34-39718; File No. SR-NASD-98-17). The comment has been prepared for the Public Interest Comment Program at the James Buchanan Center for Political Economy at George Mason University. This program produces careful and independent analyses of regulations from the perspective of the public interest. The objective of this program is to provide agencies, policy makers, and the public with analyses that reflect the interest of the average citizen.

Based on the analysis provided below, we believe the benefits of Nasdaq’s proposal appear to outweigh the costs and would therefore generate net benefits to investors. We do identify several areas where further study could be made in order to improve these systems even more.

Order Delivery and Execution System

The current Nasdaq Stock Market has several order delivery and execution mechanisms. Many orders are currently delivered by telephone to market makers for execution. Alternatively, some orders are displayed and executed through proprietary electronic communications networks. Finally, the Nasdaq operates two systems for order delivery or communication. The first of these, the Small Order Execution System (SOES), provides routing and automatic execution of small orders (up to 1,000 shares) against market makers at the best market prices. The second Nasdaq system, SelectNet, facilitates the routing of orders to market makers. While these orders do not receive automatic executions, market makers are bound by the Firm Quote Rule to honor SelectNet orders. The Firm Quote Rule currently requires that market makers honor their quoted prices for the number of shares up to their quoted size. Liability orders are orders that fall under a market maker’s obligation to honor their quotes (i.e., the Firm Quote Rule). These are orders for a number of shares less than or equal to a market maker’s quoted size.

Under the current Nasdaq system, market makers face “double liability” from having to honor their quotes when they receive simultaneous orders through SOES, SelectNet, or orders delivered over the telephone. Together, these disparate order delivery systems may cause an operational inefficiency within the marketplace if market makers must simultaneously service orders...
from all delivery points. Removing this inefficiency could benefit investors by decreasing the costs and risks to those who provide liquidity to the market.

The Nasdaq’s proposed rule establishes one unified order delivery and execution system (henceforth, the System). In replacing the SOES and SelectNet systems with a single system, Nasdaq also proposes a time delay for execution for orders of size. Specifically, the proposed rule states that liability orders up to 1,000 shares or up to the market maker’s displayed (and supplemental) size, whichever is smaller, are to be automatically executed against the market maker. However, larger orders are subject to a delay of 17 seconds (32 seconds) for orders of 1,100 to 5,000 shares (over 5,000 shares), regardless of the market maker’s quoted (and supplemental) size.

The proposal to replace SOES and SelectNet with a single system likely will enhance efficiency by which the Nasdaq market will operate. In addition to speeding execution of customer orders, the System removes part of the “double liability” problem that currently arises with SOES and SelectNet systems. In turn, this reduces a potential cost to market makers for providing liquidity to the market. Overall, this part of the proposal should benefit the investing public by utilizing technology to increase the efficiency of trading Nasdaq securities.

However, the market maker still faces double liability when the market maker receives orders simultaneously through the proposed System and either in-house systems or communication by telephone. The proposal to allow a time delay may help protect market makers from double liability. The delay allows market makers the flexibility to execute an order in the event that several orders arrive at the same time.

There are also disadvantages to the proposed time delay. First, a rule allowing delayed execution appears to suggest that a market maker’s quoted size above 1,000 shares is not subject to the Firm Quote Rule. This appears to violate the “truth in advertising” spirit of the Firm Quote Rule. It might raise the question, under what circumstances would it be legally acceptable for a market maker to reject such an order? Under the Firm Quote Rule, it appears that there would be no circumstance under which a market maker would not be liable for its quoted size, unless the market maker were simultaneously accepting an order through another system, such as an order from its in-house order routing system or an order conveyed over the telephone.

A time delay subjects orders of size (greater than 1,000 shares) to the cost of execution-price risk. Under the proposed rules, these orders can sit in the System waiting for market maker action for 17 or 32 seconds. In the meantime, market prices could be moving against the order. So, if the market maker rejects the order (for, presumably legal reasons), the order might then be subject to an inferior price than existed in the market only seconds before. Had the order been immediately executed or sent back into the System, the order would have received the best market price available to the order (from another market maker) without delay. The time delay, in addition to being somewhat arbitrary in length, thus adds a friction and potential cost to investors.
If the System were to provide immediate automatic execution of all orders, it would benefit investors by providing an order handling and execution mechanism that treats all orders up to a market maker’s depth (i.e., orders less than 1,000 shares and orders greater than 1,000 shares) the same. This would provide a transparent market in which investors would know what prices are available in the market and be able to rely on transacting at those prices when submitting an order. It would reduce execution price risk cost for investors who submit large orders. Furthermore, the benefit of flexibility for market makers that the time delay and elimination of double liability gives could be addressed with the Firm Quote Compliance Facility, which is discussed later.

Therefore, although I recommend the proposed rule be approved, further study should be conducted on the merits of removing the execution time delay entirely.

Limit Order File

Currently, the SEC order handling rules require the exposure of customer limit orders to the entire market. For firms which do not have market making operations in a specific stock, this rule forces them to send their customers’ limit orders in those stocks to a competing market maker, alternative trading system (ATS), or electronic communication network (ECN) for exposure to market interest. One would expect market makers may not value using their own customers’ orders to benefit competing market makers. Accordingly, a benefit to NASD members of the proposed rule’s LOF (essentially an alternative trading system) is that it offers a facility for exposing limit orders to the market, without necessitating the use of an ECN or competing market maker.

The proposed rule’s LOF offers the potential benefit of providing brokers with an avenue for exposing customer limit orders to public trading interest. The system also mimics features in existing proprietary systems that allow anonymity for limit orders. However, its design and implementation by Nasdaq may have long-term negative competitive effects on the marketplace, including reduced incentives for innovation that, in turn, could harm investors. Since the LOF offers a service to the marketplace that is already offered or could be offered by third parties such as Electronic Communications Networks, its approval and implementation raises issues regarding the relation between NASD as a regulator and the Nasdaq Stock Market. First, would a Nasdaq-sponsored LOF have an unfair competitive advantage due to perceived legal certainty in complying with NASD and SEC order-handling rules? Second, to what extent would Nasdaq be able to use information made available to the NASD for regulatory purposes to compete with its members in providing a service to market participants? To the extent that the relation between the NASD and Nasdaq allows information transfer, or provides Nasdaq’s systems with a perception of greater legal certainty, the implementation of the LOF proposal would lead to a wealth transfer from those NASD members who put capital at risk to develop such systems. In this situation, long-term incentives for innovation in the Nasdaq Stock Market might also be harmed.
**Sponsored Access**

The proposed rule establishes sponsored direct access to the System for individual and institutional investors. Direct access benefits investors by allowing them to establish a market presence and to trade directly with other market participants without the intervention of a broker or market maker. Additionally, the proposed sponsored access to the System reduces costs to investors in several ways. First, in bypassing the services of the broker on every trade, sponsors may be able to offer lower trading fees for those clients who trade directly through the System. Second, sponsored access removes the operational obstacles of indirect access to the market by investors. This may reduce the time required for a transaction and the operational risk that an error is might occur while an order is transmitted to the broker and executed by a third party. Finally, sponsored access may allow an investor to trade without first revealing their trading strategy to other market participants who may end up competing with the investor for liquidity.

As written, the proposed rule limits the right to sponsor access to registered market makers only. By restricting sponsorship, the rule imposes costs on brokers who would wish to sponsor access but who do not wish to actively participate in market making activities. To compete to provide sponsored access these brokers would have to incur the costs of market making operations. Future consideration and study should be given to extending this rule to allow all members to sponsor direct access, which could lower the costs to investors seeking sponsored access by further removing the impediments to competition.

**Firm Quote Compliance Facility**

The Firm Quote Compliance Facility appears to be a System-implemented “telephone button”, which when pushed by a market maker, temporarily closes a market maker’s quote. The benefit of this feature is that it removes a market maker’s double liability through the System while the market maker works to execute a telephone or in-house order. As proposed, the System would leave the market maker’s price displayed in the market, but would not deliver any System orders to the market maker for execution. This results in a publicly quoted price by the market maker that is unreachable or against which no order can be executed. Essentially, this reduces transparency in the market and provides customers with quoted prices that may not reflect the price they can receive.

An alternative that may be considered would be allowing market making firms with in-house order routing systems (for in-house customer orders) to decrease the market maker’s quoted size or change the market maker’s quoted price automatically upon pushing a button. This alternative would impose a programming cost to firms. Alternatively, the Nasdaq could provide a simple system feature (available to all System participants) that would change the function of the proposed “telephone button”. In this case, the button could automatically move a market maker’s quoted
price (at a user-definable increment) away from the current side of the quote which is at risk to the in-house or telephone order. This change could be implemented at the same time the Firm Quote Compliance Facility is being programmed for the new System. This alternative to the proposed System has the following potential benefits. It protects market makers from the double liability to System orders and to in-house or telephones orders; it improves transparency in a “what you see is what you get” marketplace; it guarantees all investors that the advertised prices are available; and ensures fast and efficient execution of orders entered in the System.

Thank you for the opportunity to comment on this proposal.

Sincerely,

Jason T. Greene
Assistant Professor of Finance
Georgia State University