COMMENTS OF
THE COMPETITIVE ENTERPRISE INSTITUTE
TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION
CONCERNING REGULATION NMS PROPOSED RULES AND AMENDMENTS
TO JOINT INDUSTRY PLANS

File No. S7-10-04
69 FR 77,424 (Dec. 25, 2004)

January 26, 2005

Dear Secretary Katz:

Thank you for giving the Competitive Enterprise Institute the opportunity to comment on Regulation NMS. Founded in 1984, The Competitive Enterprise Institute (CEI) is a not-for-profit non-partisan organization that focuses on the costs and risks of regulation and the benefits of the free market in spreading choice to consumers and businesses.

CEI applauds the Securities & Exchange Commission for taking a fresh look at its regulations on market structure. The 1975 Securities Acts Amendments gave the commission broad discretion to "facilitate" a National Market System. Much has happened since the late 1970s when the market structure policies were first implemented. Most important is that all over the world, a new consensus has emerged on the failure of command-and-control policies to deliver on its promise of fairness and efficiency to society.

So it is disappointing to see the SEC taking an even more top-down approach to market structure. The proposal to make all exchanges and ECNs display their "depth of book" would hinder incentives for technological innovation and make market centers like public utilities. As noted by academic researchers, in books such as *Technologoical Change in Regulated Industries* (Brookings Institution, 1971), public utilities have little incentive to create technological innovation

In our view, the proposal also exceeds the authority Congress gave to the SEC in 1975, because the commission would go beyond its current role of working with market centers to "facilitate" a National Market System. The SEC would now actually be *implementing* or *mandating* a specific design for a National Market System. We doubt Congress granted the SEC this authority.

We have enclosed a policy analysis from John Berlau, this year's Warren T. Brookes Journalism Fellow at CEI. As a journalist at publications such as **Insight** and **Investor's Business Daily**, John followed the development of new markets created by the Internet in the 1990s. As he points out, web sites such as eBay and Amazon.com are leading the way in developing new models of price discovery. Without any government regulation dictating the "best execution," they have found a way to create order policies that have pleased most buyers and sellers. They are a prime example of the way competition spurs innovation. And they demonstrate why the SEC's quest for "uniformity" across market centers is so misguided. Of course, the SEC, as a government entity, should itself have *uniform* rules to regulate market centers. Democracy depends upon the predictability and the certainty of law. But there is no need for exchanges or electronic communications networks (ECNs) to have uniform policies on treatment of buyers and sellers. These private "regulatory" arrangements are the way in which private entities compete with alternative methods of addressing the transaction costs that limit all market centers. "Market fragmentation" should not be seen as a problem. It's a positive feature of the free market that participants are constantly moving to the venues that offer them the best deals.

The SEC should go back to the drawing board for Regulation NMS and design a rule that is more deregulatory to reflect the trends in economic liberalization made possible by institutional and technological changes. In the near-term, it should allow the New York Stock Exchange and other exchanges to maintain the trade-through rule, but not force this policy on Nasdaq and the ECNs. In the long term, the agency should move away from the goal of "best execution," working with Congress if necessary to change the Securities Acts Amendments, to a new policy of transparency of execution policies. By "transparency," we refer to market centers' general rules, rather than specific details of transactions.

Congress did set "best execution" as a goal in 1975, but, tellingly, never defined the term. The SEC should not try to define it either, because different consumers also have different definitions of what is the best execution. Perhaps the Commodity Futures Modernization Act of 2000, the Congress passed for the futures market and the Commodity Futures trading Commission could be a model. This law gave futures market centers more autonomy in their execution policies. The best thing for the SEC to do for now is to define "best execution" as the policies that market centers and participants agree on in a competitive market.

Thanks you so much again for allowing CEI to share its views on Regulation NMS.

Respectfully submitted,

Fred L. Smith Jr.
President
Competitive Enterprise Institute
1001 Conn. Ave. NW, Suite 1250
Washington DC 20036

(202) 331-1010
www.cei.org

CEI C:\Spin

This issue: Internet Lessons for the SEC - Look to eBay and Amazon as a Model for a National Market System

By John Berlau

Warren T. Brookes Journalism Fellow

Competitive Enterprise Institute

January 6, 2005

In looking to reform government regulation of the structure of the stock exchange system, SEC regulators would do well to buy a book on Amazon a, a trip on Orbitz, or anything on eBay. These sites have two things in common. One is they have generated trust and goodwill with millions of consumers who believe that if they come to these sites they can get a good deal and be treated fairly. The second is that, unlike with stock markets, there is no government regulation dictating what the “best execution” of a bid or purchase order should be in these venues. Each site has its own set of private regulations to deal with the challenges of how to match a consumer with a dealer at a price that is agreeable to both. If either the buyer or seller doesn’t like the rules of the site, there are other venues where they can conduct their transactions.

Uniformity of Rules Creates Less Choice

These sites provide a model of what the stock markets should look like in the 21st century. And as the SEC considers a revised Regulation NMS, in which it seeks to improve the design of what it and Congress have termed the “National Market System,” the commission should be focused on moving toward the free-market system fostering competition that has worked so well for trading venues on the Internet. As Alfred Berkeley, former President and CEO of the Nasdaq stock market has written in comments to the commission: “The country is experiencing a surge in innovation in market structure in many other segments of the economy. New models of demand aggregation and price discovery are benefiting consumers. … We need to permit change in our equity markets as well.”

But unfortunately, the changes the SEC commissioners voted 4-1 on Dec. 15 involve government command-and-control over the operations of the stock exchanges, the Nasdaq stock market, and the fledgling electronic communications networks (ECNs) in a misguided quest for “uniformity.” The problem can be traced to the commission’s approach. In the first draft of the proposed rules in February, the SEC speaks of “the need for uniform rules that promote equal regulation of, and free competition among, all types of market centers.” But it then frets that “there is disparity in rules across markets,” such as the fact that some markets have sub-penny quoting and some do not.

In this and other instances, the SEC is confusing its own rules governing the market centers with the trading facilities’ internal policies for participants. There is a crucial distinction to be made between these two concepts. While the government and the SEC itself should of course strive for equal regulation and not discriminate against any particular market center, the “disparity in rules” across stock trading venues should be no more of a concern to policy makers than the “disparity in rules” among Orbitz, Travelocity and Expedia or among Amazon and eBay’s Half.com booksellers. Indeed, it is this “disparity” that ensures the “free competition” the SEC says it wants to foster. And eliminating the internal rule differences between market centers would greatly reduce the competition and innovation that serves businesses and investors.

Uniformity Limits Innovation

Unfortunately, the revised regulation just put forth for comment by the SEC would go even further than the first draft in centralizing and micromanaging the markets for trading securities. The SEC has now unveiled the latest variation of the CLOB, a so-called central limit order book which would require markets to share all their pricing information about different orders and automatically route buyers to a certain seller based on an arbitrary definition of “price/time” priority. According to an SEC summary put out after the vote, the regulation would “establish a uniform market access rule” through a mandated “private linkage approach.” Trading venues would likely have to display what the SEC calls the “depth of book,” meaning virtually all bids and offers, to other market centers. The rules also “would harmonize the pricing of quotations across different market centers by limiting the fees that any trading center could charge,” in effect putting price controls on what trading venues can charge their participants.

Ideas for the CLOB and its variations have been proposed since the 1970s by some SEC staffers and academics. But while technology has improved since ‘70s, the problems with such a proposed system remain the same. Aside from the cost of building such a system, the price controls and mandated information sharing would limit innovation. The newly formed ECNs would lose incentive to create faster and more efficient trading models and the exchanges would lose incentives to invest in technology other than that which is expressly needed to fulfill the mandated system.

The criticism of a CLOB-like system by former Democratic SEC Commissioner Roberta Karmel, who was appointed by Jimmy Carter in 1977, still rings true. “The specifications of such systems,” Karmel wrote in her 1982 book Regulation by Prosecution, “essentially are operational design matters, and they should not be decided by a lawyer dominated government agency. Such regulatory standard setting eventually leads to technological stagnation, and an unhealthy dependent relationship between a regulator and regulated industry, even if the systems initially designed are the best then available. Further, the SEC does not have special expertise or experience in computer science, or a large number of staff economists. National market systems for securities trading and clearance should be determined by technology and business needs, not politics." Indeed, it's fair to say that if Karmel and others hadn't been successful in stopping the one-size-fits-all CLOB in the '70s, we probably wouldn't have the fast-trading technology we have today.

Furthermore, market centers have valid reasons for not wanting to instantly share all information on the buying and selling intentions of their participants, as may be required in a the SEC's proposed CLOB-like system. Withholding some information can benefit the welfare of public companies and long-term investors. It can, for instance, prevent short-sellers or arbitragers from having too much of an influence on a stock's price. Former Nasdaq President Berkeley, who is now chairman of the New York-based alternative trading system Pipeline, argues that "[t]he requirement that investors must display their trading intentions to the market before they trade puts the full force of federal regulation behind a bias against investors and investment and in favor of speculators and speculation." There is nothing wrong with short-sellers, arbitragers and other speculators, but market centers shouldn't be forced to throw open all the pages of their books to make it easier for them to conduct their deals.

Regulators Should Pursue a Free Market System (FMS)

In setting a market framework for the 21st century, the question should not be as much what the regulations should be, but who should be doing the regulating. The goal of mandating the "best execution" for an investor, which Congress and the SEC have pursued since the passage of the 1975 Securities Acts Amendments, should be changed to a focus on transparency in market centers' execution policies. "Market fragmentation" --- customers and dealers going to different venues that serve them best --- should not be considered any more of a problem for the stock markets that it is for commodities that can be bought on the Internet. Exchanges, the Nasdaq, ECNs as well as new forms of alternative trading systems should be free to compete with their own policies for the best execution of a trade. As Dale Oesterle, a professor at Ohio State University School of Law who specializes in securities markets, put it in a paper for the American Enterprise Institute, stock "[t]rading markets are no different from any other service markets: the more competition the better, the less government intervention the better."