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February 1, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Regulation NMS, File No. S7-10-04

Dear Mr. Katz:

Charles Schwab & Co., Inc. and its affiliates ("Schwab") appreciate the opportunity to comment on the re-proposal of Regulation NMS and the Commission's proposed restructuring of the equity markets.

As agents executing orders on behalf of millions of individual investors and independent investment advisors, and as mutual fund investment advisors trading in the market on behalf of millions of mutual fund holders, we appreciate the degree to which market structure directly affects the efficient operation of the markets and execution quality for customer orders. With Regulation NMS and its alternative proposals for expansion of the trade-through rule, the Commission has proposed a fundamental redesign of the equity markets that redefines the role of market participants and even the role of the Commission itself. Indeed, for the first time, the Commission proposes to dictate how orders are handled in the markets, substituting a government-designed algorithm for the interaction of competitive market forces.

For the following reasons, Schwab urges the Commission to reconsider its proposed redesign of the equity markets:

<u>Trade-Through Proposals</u>

- **The design of order routing algorithms, new order types, and market linkages is a role best left to the markets.** Congress has recognized a critical role for Commission oversight and facilitation of competition, but has consistently reaffirmed that competitive market forces should shape market structure.

- **A single, one-size-fits-all order handling algorithm for the entire stock market.** Regardless of which of the proposed trade-through rules it were to adopt, the Commission would be dictating order-routing and execution practices down to the identical order-routing algorithm. Either variant forces participants on one market to route to other markets quoting better prices, regardless of whether they'd get a better overall price or faster print on their own market.

- **A CLOB by another name.** The Commission has said it seeks to avoid the extreme of "a totally centralized system that loses the benefits of vigorous competition and innovation among individual markets."[1] Although the Commission's intent apparently is not to replace individual markets with a single market (often referred to as a central limit order book or CLOB), a single, government-designed algorithm for order routing would have the same effect by dictating, on an order by order basis, how, where and at what price market participants must trade.

- **A centralized routing algorithm stifles innovation of new mechanisms for handling orders.** With a trade-through rule, there is no incentive for markets to compete on how they execute orders and discover prices and depth. A single algorithm specifying the same handling for every type of customer would be substituted for a broker's informed discretion about the best execution venue for an order.

- **Execution quality and market efficiency.** Best price and technological and operational efficiency, the hallmarks of our current market structure, are inevitable casualties when markets have no incentive to invest and innovate, and when market participants all using the same government-designed algorithm are forced to chase the same quotes at the same markets whenever they execute orders.

- **The proof is in the numbers.** In our experience, market quality (quoted and effective spreads) in the Nasdaq 100 Trust (QQQQ) saw a significant improvement last fall when the listing transferred to Nasdaq, which is not subject to a trade-through rule. Buy-side and sell-side traders alike (other than specialists, of course) universally prefer the Nasdaq-listed market as the more efficient and flexible market structure.

- **No empirical evidence to support a trade-through rule.** The Commission's own analysis finds similar rates of trade-throughs (approximately 2.5%) for listed stocks, which are already subject to a trade-through rule, and Nasdaq

[1] Re-proposing Release at 77426

stocks, which are not. More refined economic analysis presented by other commenters find trade-through rates as low as 0.22% to 0.4%.[2] Our experience is that trade-throughs are infrequent and largely attributable to extenuating factors such as locked and crossed markets, fast markets and stale quotes. In any event, such a small percentage of trade-throughs (even by the Commission's estimation) would hardly justify a complete redesign of the market affecting how all orders are handled.

- **Expanding the trade-through rule will not increase limit orders.** There is no evidence to support the premise that a trade-through rule will encourage customers to enter limit orders. Indeed, our own customers tend to use limit orders approximately twice as often for Nasdaq-listed stocks (the market without a trade-through rule) as for exchange-listed stocks. Even the Commission's own data finds significantly greater use of certain limit orders (marketable limit orders) for Nasdaq-listed stocks than for exchange-listed stocks. In any event, in the equity markets, where larger traders are sensitive about displaying size and all traders are sensitive to getting "pennied" (ceding priority to other traders quoting one tick better), there are natural, overriding constraints on customer use of limit orders.

- **Competition and best execution duties already drive markets to protect customers against trade-throughs.** Brokers already demand trade-through protection from the markets to which they route orders. As every specialist and market maker knows, a customer who receives an out-of-range print (a price that's inferior to the best displayed quote) is going to be due an adjustment, regardless of which market they traded on.

Market Data Proposals

Every investor, large or small, receives a quotation when placing an order to buy or sell a security. This market data, known as the "National Best Bid and Offer," along with "Last Sale" data that tracks the price of the last trade in a security, informs millions of daily investing decisions. It has the potential to make our markets transparent so that every investor, large or small, can know what price they are going to pay, and can determine whether they received best execution of their order. Needless to say, the quality of and access to this market data is vital to the functioning and fairness of our markets. However:

- **The market data system is badly broken, both in terms of the quality of the data and assuring reasonable and fair access to it.** There is too much unaccountable money washing through the system, and the quality of today's quotation in terms of informational value is minimal. The SEC's approach

[2] *See, e.g.,* letters from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company, January 26, 2005, at 8; and Edward S. Knight, NASDAQ, January 26, 2005 at Exhibit I, pp. 2-5.

under re-proposed Regulation NMS falls far short of addressing the serious issues that Schwab and many others – including the Securities Industry Association – have pointed out again and again.[3]

Under current SEC rules, the securities exchanges (including Nasdaq):

- **Operate as a cartel** to fix the price of market data;
- **Fail to justify the fees** they charge investors and broker-dealers in terms of any articulated standard of reasonableness or fairness or any reference to the cost of compiling the data;
- **Operate without public representation** or input;
- **Spend market data revenues as they see fit** to fund proprietary or competitive activities;
- **Restrict and control distribution of the data** through contracts of adhesion;
- **Impose idiosyncratic and costly reporting, accounting, and recordkeeping burdens** on broker-dealers who are simply giving their clients access to market data to make informed investment decisions.

The Commission, in the re-proposing release, agreed with Schwab and others that "the level of market data fees should be reviewed and that, in particular, greater transparency concerning the costs of market data and the fee-setting process is needed."[4] The Commission also stated "that comprehensive trade and quote information, even beyond the NBBO, is vital to investors."[5]

Despite those statements, the re-proposal fails to address any of these well-documented problems, despite five years of ongoing study and debate.[6] Instead, the re-proposal would address a single effect – not even a root cause – of market data's multiple maladies: the gaming of a few to capture share of the excessive market data profits. The re-proposing release states that, by re-jiggering the allocation formula the exchanges use to divide the market data revenue spoils, and by establishing a perfunctory non-voting advisory committee to the cartels, the Commission is taking "first steps" followed by yet another concept release (this one on SRO governance and regulatory funding). These "first steps" are inexplicable after five years of study and debate. Meanwhile, the market passes by the SEC's antiquated rulebook, with rapid changes in technology, the impact of decimalization, and exchanges transforming into profit-making enterprises. The contrast

[3] *See* June 30, 2004 Letter from Carrie E. Dwyer on Regulation NMS ("First Schwab Comment Letter"); Regulation NMS, Release No. 34-50870 (Dec. 16, 2004) (footnote 301, citing First Schwab Comment Letter, SIA Comment Letter, and 12 other comment letters). In this letter we will not repeat the detailed analysis and points raised in both Schwab's and others' initial letters on the first Regulation NMS proposal, but they are still valid and largely unanswered by the Commission.

[4] Regulation NMS Release at text accompanying footnote 301.

[5] Id. at text following footnote 295.

[6] *See* First Schwab Comment Letter at 2-3 (reciting steps in the long history).

to the Commission's far-reaching and experimental re-proposal for the trade-through rule could not be more striking.

To solve the market data problems squarely in front of the Commission, **a new regulatory approach is necessary with the following elements**:

- **fees set based on the cost** of consolidation as established through an independent accounting;
- **public participation** in the governance of the cartels;
- a simple uniform fee structure and rules that **minimize administrative burdens**; and
- inclusion of **additional information on market depth in the consolidated quote** stream to increase market data quality so that investors are not disadvantaged.

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Thank you for the opportunity to share our thoughts on these issues of critical importance to our markets.

Sincerely,

Jeff Brown

cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Annette L. Nazareth, Esq., Director, Division of Market Regulation
Robert L. D. Colby, Esq., Deputy Director, Division of Market Regulation