CIBC World Markets

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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rule-comments@sec.gov

Re: Comments of CIBC World Markets Corp. Regarding Regulation NMS
(File No. S7-10-04)

Dear Mr. Katz:

CIBC World Markets Corp. ("CIBC World Markets") thanks the Securities and Exchange Commission (the "Commission") for the opportunity to comment on the reproposed Regulation ("Reg") NMS.[1] We commend the Commission on its thoughtful consideration of the views of market participants who will be impacted by this groundbreaking proposal. Given that Reg NMS would dramatically alter secondary market structure for equity securities, the Commission's attention to detail is admirable.

We agree with the Commission's objective of developing rules that guide market forces to promote greater order interaction and displayed depth, equal and free competition among market centers, and maximum market efficiency. While we join generally in the positions asserted by the Securities Industry Association ("SIA") in its letter, dated February 1, 2005, we are writing specifically to emphasize one point that we believe is crucial to ensuring the continued efficiency of the national market system.

CIBC World Markets believes that if the Commission adopts an intermarket trade-through rule as proposed in Reg NMS, whatever the final form of the rule, it must contain an exception for the most liquid, most actively traded stocks. Imposing a trade-through rule where trading is highly automated and efficient will neither improve execution quality nor protect limit orders in a meaningful way. Further, we believe that the rule will magnify the well-known problems associated with flickering quotes. Accordingly, we urge the Commission to add a "liquidity exemption" to Reg NMS as proposed in the SIA letter. We further submit that such exemption should apply to stocks for which quotations update on average every three seconds or less, at a minimum.

We start from the premise, as the Commission observed in the original Reg NMS Release,[2] "in a fully efficient market with frictionless access and instantaneous executions, trading through a better-displayed bid or offer should not occur."[3] The Reg NMS Reproposal goes a long way to ensuring that the U.S. equity markets will develop automated execution systems to enhance efficiency. But, for the most liquid stocks, we believe the markets have already reached this level of efficiency, rendering a trade-through rule unnecessary.

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[1] SEC Release No. 34-50870, 69 F.R. 77424 (Dec. 27, 2004) ("Reg NMS Reproposal").
[2] SEC Release No. 34-49325, 69 F.R. 11126 (Mar. 9, 2004) ("Reg NMS Proposal").
[3] Reg NMS Proposal, 69 F.R. at 1129.

Experience shows that execution quality in the most liquid stocks is extremely high. In large part, this is due to the Commission's many regulatory initiatives that resulted in improved execution quality and increased order interaction. From early efforts to protect customer limit orders to recently mandated decimalization, the Commission has taken dramatic steps to improve our overall market structure. Since the passage of Rules 11Ac1-5, investors now have more information than ever to evaluate execution quality.

The other major contributor to the dramatic increase in trading efficiency is the increasing use of technology for order transmission, routing and execution. Initially, technological limits were often the cause of market instability.[4] Over time however, the trend of technology has been to minimize volatility, improve efficiency and reduce transaction costs.[5] From the creation of alternative trading systems to the more recent development of "smart" routers and trading algorithms, it is impossible to predict how technology will evolve or how the business of trading equities will be affected by these changes. Technology reduces execution time, reduces spreads and increases interaction of market participants. The demands of the marketplace are the only limit on the extent to which technology can advance this model.

These developments have had the most dramatic impact on the most actively traded stocks. Trading volume has increased to the point where it is not uncommon for a single stock to trade ten millions of shares a day. Since the implementation of SuperMontage, the NASDAQ National Market has become highly efficient, handling some of the highest volume stocks, with the tightest spreads, in the national market system.

The competitive forces that created our market structure cannot – and should not – be dampened by regulation. Competition among market centers to attract order flow is greater now than ever in history. While regulation may be used to correct fundamental unfairness or inefficiency, unnecessary regulation hampers competition. We believe that competition naturally tends to eliminate inefficiencies and increase order interaction over time. As markets become more efficient, regulatory initiatives that impose restrictions on an order-by-order basis are harder to implement and less effective because, when executing millions of orders a day, market centers no longer compete effectively by executing one order at a time.

The improvements in market structure have also created new challenges, one of which is the well-known phenomenon of "ephemeral" or "flickering" quotes. Flickering quotes create problems like bandwidth consumption and decreased price transparency. They also, however, substantially increase the burdens on broker-dealers to comply with regulatory obligations, such as best execution, on an order-by-order basis. Indeed, the Commission rejected the sub-penny quoting proposal in Reg NMS, in part, because of its concern about the complexity of managing best execution obligations in a flickering quote environment.[6]

For the same reason, we believe that the Commission should be concerned about imposing a trade-through rule in an environment of flickering quotations. Indeed, the

[4] *See, e.g.,* SEC "Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets" (Nov. 26, 1997) (discussing system limits contributing to market breaks in 1987 and 1989).
[5] *See id.* ("Overall, automation has enhanced operation of the secondary markets, and markets and market participants have used technology to create innovative solutions to problems.").
[6] Reg NMS Reproposal, 69 F.R. at 77456 ("Flickering quotations that can result in from widespread sub-penny pricing could make it more difficult for broker-dealers to satisfy their best execution obligations and other regulatory responsibilities.").

Commission implicitly recognized this principle by proposing Reg NMS Rule 611(b)(8), which provides a one-second exception to the trade-through rule stating: "The trading center displaying the protected quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction."[7]

While we agree with the impetus for the 611(b)(8) exemption, we believe that the relief should be broader for securities where flickering quotes are the norm. In the first place, where trading in a stock has achieved a level of liquidity where quotations rapidly update throughout the regular trading period, we believe the exemption should not apply on a trade-by-trade basis. Second, we believe that the proper time period to identify a flickering quotation is three seconds, not one second as proposed in the (b)(8) exemption.

In an environment where quotes are changing at a sub-second pace, the only way to comply with a trade-through rule would be through automation. It is simply not possible for a human being to ensure trade-through compliance when quotes update within seconds. Further, because the (b)(8) exemption only applies to quote changes that occur after execution, it is literally impossible to determine when a trade occurs whether the individual execution is or is not in compliance with the (b)(8) exemption. Thus, compliance would have to be measured on an aggregate, statistical basis using data akin to the 11Ac1-5 reports. Relying on that type of data to determine compliance with a trade-by-trade rule, however, would be extremely difficult.

Perhaps the most persuasive evidence for our position is found in the report prepared by the Commission's Office of Economic Analysis ("OEA") in connection with the evaluation of the Reg NMS proposal.[8] The OEA explained that any analysis of trade-through rates is highly "sensitive to the calculation methodology."[9] This is due to basic limitations in available data, as well as complexities resulting from frequent quote changes and system time lags. Due to these limitations, the OEA's data showed that trade-through rates increased in the most active stocks, in both NASDAQ and NYSE stocks. Questioning the reason for this, the OEA observed, "[t]his apparent relationship between trade activity and trade-through rates may reflect the difficulty of avoiding trade-throughs in active markets, or less precision in trade-through estimates of active stocks."[10]

We submit that the OEA's supposition is entirely correct. Attempting to measure trade-through rates in the most active securities is, at best, imprecise. At worse, we believe it is a potentially dangerous exercise because it will create a false impression of inefficiency and non-compliance. "False positives" are problematic because they impose tremendous costs in sifting through data to determine whether apparent exceptions are indeed violations, or not, on a trade-by-trade basis. Further, the unintended consequence of this exercise is that false violations may harm investor confidence in the market – for no reason at all.

We believe the OEA report supports the notion that the trade through rule should not apply to quotes that update on average every three seconds, at a minimum. Taking a blunt approach to trade-through analysis results in numerous "false" trade throughs – in

[7] Reg NMS Reproposal, 69 F.R. at 77519.
[8] OEA Mem., *Analysis of Trade-throughs in NASDAQ and NYSE Issues* (Dec. 15, 2004).
[9] *Id.* at 1.
[10] *Id.* at 4.

other words, statistical aberrations that do not represent executions that actually trade through better-displayed prices. Notably, the OEA determined that the fairest analysis of trade-through rates was to use a “three-second quote window,” in which an execution price was not deemed a trade-through when the apparently traded-through quote was not displayed for the full second before and the full second after the second in which the trade execution was reported.

In a stock that is so active that quotes are updated within a three-second window, the fact that some limit orders may be traded through should not be viewed as a problem. The intent of the trade-through rule is primarily to protect limit orders that are providing price discovery and liquidity, by prohibiting traders from bypassing that order to trade at a less favorable price. But, there is no suggestion that limit orders are being bypassed in the most active stocks. In the most liquid stocks, extremely large orders can be executed quickly and efficiently without market disruption. There is virtually no chance that an order of any reasonable size will go unexecuted.

In this environment of super-fast, highly automated trading, injecting a complex regulation like the trade-through rule Reg NMS threatens to slow down innovation and harm execution quality. When competition alone has essentially achieved an “efficient market with frictionless access,” the trade-through rule will do more harm than good. It will result in wasted resources sifting through market data to eliminate false trade-throughs, and trade-throughs for economically insignificant sums. We also believe that this task will be inordinately expensive, both in terms of the hard dollars required to build systems and pay for market data to do surveillance and the lost opportunity cost of resources that could be spent investigating execution quality in less liquid stocks. This use of resources, we believe, will not improve execution quality or encourage posting of limit orders for highly liquid stocks.

In conclusion, CIBC World Markets believes it is imperative that the Commission add a liquidity exception to the trade-through rule for actively traded securities. We submit that execution quality in a stock that has quotes that update three seconds on average will not benefit from the imposition of a trade-through rule and, further, that attempts to measure compliance with that rule would result in false data that would have a negative impact on investor confidence. For the most active stocks, the Commission should be able to rely on existing best execution obligations to ensure that market participants obtain the best available prices for investors.

Very truly yours,

/s/ Bruce C. Turner

Bruce C. Turner
Managing Director

cc: Chairman William H. Donaldson
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Commissioner Roel C. Campos
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