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January 26, 2005

U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549-0609

Attention: Mr. Jonathan G. Katz, Secretary

Re: File No. S7-10-04, Regulation NMS, Release No. 34-50870 (December 16, 2004) (the "Release")

Ladies and Gentlemen:

I am writing on behalf of Fidelity Investments, as investment manager of the Fidelity Group of Funds, to offer our views on the Commission's re-proposed Regulation NMS, announced in the Release. The Commission has invited comment on two versions of an inter-market trade-through rule: (1) one that would "protect" only the best bid and best offer displayed in each market center for any stock (the "Top of Book" rule) and (2) another that would "protect" additional bids and offers below each market center's top of book if the market center chooses to designate those additional limit orders for protection (the "Depth of Book" rule). At the Commission's open meeting last December, Commissioner Glassman urged her fellow Commissioners to seek public comment on a third approach: namely, that the Commission stay its hand and adopt no trade-through rule at all.

We write with the understanding, widely shared among those who have followed the circuitous path of this rulemaking proceeding, that the proposed Depth of Book rule is DOA (dead on arrival) at the Commission. For the record, Fidelity opposes the Depth of Book rule for the same reasons that we oppose a Top of Book rule, as we have explained in our prior comment letters in this proceeding.

Accordingly, we urge the Commission to heed Commissioner Glassman and to adopt no trade-through rule at all. So long as bids and offers are made available to investors on a timely and continuous basis, and investors have ready access to competing market centers, the

government need not – and should not – deprive investors of the freedom to choose among markets. This is especially so for institutional investors who owe fiduciary duties to the funds or accounts under their management. With market transparency and accessibility, we are convinced that the markets will make appropriate adjustments to suit their own competitive advantages and will structure their business models to attract order flow – redounding to the benefit of all investors.

We will not repeat in this letter all of the points that we have sought to make in our prior comment letters, but instead wish to address three matters: (1) the sequence for Commission consideration of a trade-through rule and the NYSE's "hybrid market" proposal, (2) the re-proposed rule's dropping of the "opt-out" right for informed investors and (3) the internal economic study that the Commission has made public regarding the need for a trade-through rule.

I. The NYSE's hybrid market proposal and the Commission's trade-through rule proposal

We have heard from many quarters that one important reason to support the Commission's trade-through rule proposal is to animate the New York Stock Exchange to transform itself from a "slow" market to a "fast" one – a market that will allow for automated trading, including automated "sweeping" of its limit order book. If this view has merit, we suggest that the Commission need not necessarily ***adopt*** a trade-through rule to achieve the desired end; it merely needs to ***propose*** such a rule, as it has already done, to provide the necessary incentive to the NYSE to propose to transform itself into a "fast" market.

The NYSE has, in fact, proposed a hybrid market proposal that purports to allow for automated trading of orders, regardless of their size. We are encouraged by this step, although we have a number of concerns regarding the NYSE's proposal, which we have set forth in prior comment letters. For its part, the NYSE, through its representatives, has stated to us that its hybrid market proposal does ***not*** depend on the Commission's adoption of a trade-through rule.

It seems to us that the Commission should first take up the NYSE's hybrid market proposal for consideration before acting on its own proposed trade-through rule. Does the NYSE rule effectively respond to investors' needs? Will it transform the NYSE into a fast market? Should floor members and specialists be allowed to insert undisclosed orders into the NYSE's electronic limit order books? With regard to all trading on the NYSE, should the NYSE be required to grant time priority (as its rules currently do not do) to investors' orders entered in the specialist's limit order book over orders that are sent to floor brokers later in the trading day? These are issues concerning the NYSE's market that should be addressed by the Commission on their own terms – before the Commission decides whether an ***inter-market*** trade-through rule is necessary or appropriate.

II. **The "Opt-Out" Right**

The Release proposes to drop the "opt-out" right that the Commission included in its initial trade-through rule proposal. We urge the Commission to retain the opt-out right and do not believe that the Commission's rationale for dropping it is sound.

The Commission recognized in its proposing release that an informed investor may have legitimate reasons to choose to send its order to a particular market center, even though another market center may be displaying opposite-side limit orders at a price superior to the price that the investor is willing to pay or receive in its market center of choice. This is particularly true for institutional investors, like the Fidelity funds, that typically trade in large blocks. The Commission observed (at p. 23) of its proposing release:

> "Large traders may … want the ability to execute a block immediately at a price outside the quotes, to avoid parceling the block out over time in a series of transactions that could cause the market to move to an inferior price.
>
> "A further benefit of providing investors with the flexibility to choose whether their orders should trade through a better quote is that it might create market forces that would discipline markets that provided slow executions or inadequate access to their markets. If investors were not satisfied with the level of automation *or service provided by a market center*, they could choose to have their orders executed without regard to that market's quote, thus putting pressure on the market to improve its services." (emphasis added)

In its new release, the Commission explains that a trade-through rule that applies only to markets with "fast" quotes obviates the need for an opt-out right for informed investors. We respectfully, and strongly, disagree.

- Even if markets are fast, the risk remains real, and substantial, that an institutional investor, seeking to acquire or dispose a large block of stock will be put to a distinct and unfair disadvantage if it is deprived of the ability to negotiate, at one time and at a specified price, an all-in price for its block trade with a dealer. It is not unusual for one or more Fidelity funds to do block trades in sizes of 500,000 shares, one million shares or even more. It cannot be assumed that the displayed liquidity across market centers under a trade-through rule will always – or typically -- be sufficient to satisfy even a significant portion of our funds' block trades. As a result, whether markets have fast quotes or not, our funds, in trying to do a block trade, will be compelled, by governmental rule (to borrow the Commission's own words), to "parce[l] the block out over time in a series of transactions that could cause the markets to move to an inferior price."

- We urge the Commission to recognize that the "further benefit" of disciplining market centers that an opt-out right will afford will apply not only to "the level of automation" of a given market center but also to other services to which the Commission itself alluded in its initial release. By dropping the opt-out right, the Commission will seriously impair the ability of an informed investor to "discipline" a market center for other legitimate reasons – for example,

    - high transaction fees,

    - high fees for viewing limit orders away from the best bid or offer,

    - unfair informational and trading advantages given to members solely by virtue of their presence on a trading floor,

    - leakage of information by floor members regarding the identity of a large investor seeking to trade in large quantities in a given stock on a given day,

    - abusive trading by specialists or floor members that are not promptly addressed by the market center's surveillance and enforcement arms,

    - the ability of floor members to reap the benefit of "free" puts and calls represented by investors' limit orders, a benefit that facilitates "penny jumping" by floor members – a practice that would survive a trade-through rule for the very reason that such trading takes place inside the spread, and

    - failure of a market to give time priority to limit orders over orders sent to floor brokers later in the trading day.

  We respectfully submit that it ill behooves the government to decide that the only legitimate interest that an informed investor may have in choosing among competing market centers is whether a market center has "fast" quotes that happen to meet the minimum threshold set by the government as to what constitutes "fast."

- In proposing to eliminate the opt-out right, the Commission, inappropriately, is choosing to confer advantages to some investors over others. As noted above, the ability to do block trades quickly, and at a specified price, is a legitimate interest of an institutional investor – an interest, we submit, that bears directly on the ability of the institutional investor to obtain best execution at an "all-in" price. The Commission implicitly acknowledges this legitimate interest of the institutional investor in its re-proposing release (at p. 59), stating that "advocates of the opt-out exception have failed to consider the interests of <u>all</u> investors – both those who submit marketable limit orders and those who submit limit orders."

Precisely. We submit that our fiduciary duty is, and must be, to consider the interests – **and only the interests** – of the Fidelity funds and their shareholders. The government should not be in the business of tilting the scales against mutual funds and other institutional investors to favor other participants in a free and open market. We hasten to add that this is not a "big investor vs. small investor" issue. The average account of a shareholder in a Fidelity domestic equity fund is roughly $10,000. We suggest that this average account size is smaller than the account size of the typical individual investor maintaining an account at many, if not most, full service brokerage firms.

- The Commission advances as a reason for depriving institutional investors of an opt-out right that these investors "free ride" on prices established by retail-sized displayed limit orders. We seriously question the underlying economic assumptions of this position. The price-formation process in our equity markets reflects information stemming from all trading interests, and institutional trading is an important part of that price-formation process. Almost a third of the reported volume on the NYSE in 2004 was of block size, typically representing undisplayed institutional trading interest.[1]

- "Upstairs" market makers have substantial information on the trading interests of their institutional customers and they use that information in determining the prices at which they are willing to buy and sell securities. In turn, exchange specialists and OTC market makers benefit from the information they are able to glean about institutional trading interest and that information influences the specialists' and market makers' trading behavior. It could as easily be suggested that those who post limit orders have gotten a free ride on the complex and costly research and pricing methodology that institutional investors employ in determining the prices at which they will buy or sell, which is in turn translated

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[1] For 2004, blocks (trades of 10,000 or more shares) on the NYSE as a percentage of aggregate NYSE reported trading volume were as follows:

January	38.5%	February	36.1%
March	33.9	April	33.2
May	29.2%	June	30.2
July	30.5	August	27.6
September	29.8	October	31.0
November	29.9	December	31.2

Source: NYSE Online Fact Book, available at:
http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=655&category=3

into the prices at which the specialists and other market makers are prepared to transact.

- The Commission does not discuss in the re-proposing release the economic literature relating to the impact of block trades by institutional investors in the price discovery process. *See*, for example, Keim and Madhaven., "Aggregate Price Effects of Institutional Trading: A Study of Mutual Fund Flow and Market Returns" (Wharton 1999). We believe that it is incumbent upon the Commission to address available economic studies if it proposes to eliminate its earlier proposed opt-out right for informed investors on the unproven hypothesis that institutional investors "free ride" on prices displayed by retail-sized limit orders.

In the place of an opt-out right, the Commission is proposing a "benchmark order" exception. This exception would allow a block trade in one market to "trade through" superior opposite-side quotes on another market if the benchmark order is executed "at a price that was not based, directly or indirectly, on the quoted price of the … stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made."

The example of a benchmark order offered in the re-proposing release (at p. 87) is a block trade of 100,000 shares to which a dealer commits at 9 a.m., at a price equal to the volume-weighted average price ("VWAP") from the opening until 1 p.m. The benchmark order exception would allow the dealer to execute the trade at 1 p.m. even though the VWAP would result in a trade-through, in the Commission's words, of "better-priced protected quotations at other trading centers."

- The Commission offers little explanation as to why this type of trade-through is acceptable, whereas trade-throughs at dollar-specific prices at the time of the commitment by a dealer to its customer somehow are not. We submit that no meaningful distinction can be – or should be – drawn between the two types of block trades. The benchmark order exception recognizes the legitimate interest of an institutional investor to negotiate a single, all-in price for a block trade, without tipping its hand to the market by being forced to parcel out its trading interest over the course of the trading day (or days). If this is a legitimate interest (and it is), the institutional investor should be free to negotiate a dollar-specific price with its dealer.

- The Commission observes in the re-proposing release that "Of course, any transactions effected by the broker-dealer during the course of the day to obtain sufficient stock to fill the benchmark order would remain subject to Rule 611 [the trade-through rule]." ***But the duty of a dealer, as opposed to an investor, to avoid trade-throughs in assembling or disposing a block does not depend on whether the investor is afforded an unequivocal opt-out right or merely a benchmark order exception.*** In either case, the Commission could impose a

trade-through rule on the dealer, but allow the investor to negotiate a block trade with the dealer at a dollar-specific price.

- While we applaud the Commission for recognizing the needs of institutional investors to enter into block trades, we strongly urge the Commission to reconsider how it would allow for block trades to occur, if the Commission were to adopt a trade-through rule. A benchmark order exception, even one that allows for negotiations at price points better than VWAP (for example, a block trade in which an investor buys at VWAP minus 2 cents per share), appears inadequate for the needs of the Fidelity funds. A benchmark order introduces the very uncertainty over price that a fund manager seeks to avoid by entering into a block trade in the first place. It is likely to be of little solace to a fund manager who directs the trading desk at 10 a.m. to lock an all-in price for one million shares of a stock, to learn at the end of the trading day that the desk was able to negotiate a benchmark order trade of VWAP minus 2 cents per share, if the VWAP for that stock is up 20% over the prior day's close.

III. The Commission's Economic Studies Regarding the Need for a Trade-Through Rule Are Flawed.

The Commission has posted the work of its Office of Economic Analysis relating to the need for a trade-through rule, including the extension of such a rule to the market for Nasdaq securities. We caution that the Commission's analysis, particularly as set forth in the OEA's study entitled, "Analysis of Trade-throughs in Nasdaq and NYSE Issues," dated December 15, 2004, is open to serious question and likely rests on serious methodological flaws. We have reviewed the comment letter filed today by Professor James J. Angel. Associate Professor of Finance, Georgetown University and believe his criticisms have substantial merit. (Fidelity did not engage Professor Angel to conduct his review, and we were not privy to any of his work in this regard prior to the filing today of his comment letter.)

In his letter, Professor Angel points out several flaws in the OEA's analysis, including:

- The Commission's analysis "focuses on trade-through rates that include trades larger than the quoted size. This is clearly in error. Even in a hard CLOB environment, orders larger than the inside quote would still "trade-through" the inside quote in effect at the time the order was received."
- "The reproposing release relies upon statistics generated in today's market with manual markets and stale quotes."
- The problem of "flickering quotes"
- The inclusion of block trades, "even [if] all of the pieces of the trade were within the BBO when they were originally made."

- Overstatement of the "benefits of eliminating alleged trade-throughs" since "trading is for the most part a zero-sum game. … If a mutual fund's order on one automatic market is traded through by another mutual fund's order on another automatic market, one cannot say that mutual fund investors as a whole have been harmed by the trade through."

Our own preliminary review of the OEA's study suggests that trade-throughs of displayed superior orders equal to or greater in size than the incoming "trading-through" order may amount to only 0.4% of Nasdaq volume, and perhaps only 0.22% of NYSE share volume – hardly sufficient to justify the intervention of the federal government to deny investors the freedom to choose the market where their trades are to be executed. The overstatement of limit orders traded through in the OEA's analysis necessarily carries over to the OEA's estimate of the total dollar "loss" occasioned by trade throughs. Our preliminary estimate, even assuming the Commission's theory of "loss" arising from trade throughs, is in the minimal range of $16 million per year.

We expect that access fees, leading to locked and crossed markets, may have been a primary cause of many of the perceived trade-throughs, that "race conditions," resulting from attempts to sweep the market, may well have been responsible for others and the activation of reserve quantities for still others In any event, it is not necessarily the case that a limit order placed in one market center that was traded through by another market center would have been executed at its limit price had it been presented in the second market. It may well have lost out to other orders presented to that market at or about the same time. As a result, the "benefits" to investors of preventing trade throughs are by no means clearly established. Without further, more detailed information on the actual trades themselves, we cannot be sure what the data in the Commission's trade-through study show.

In light of these serious questions regarding the OEA's findings and methodology, we urge the Commission to direct OEA to conduct further evaluations of trade throughs, particularly purported trade throughs in the Nasdaq market. Those further evaluations should look not only at the publicly available data filed under Securities Exchange Act Rule 11Ac1-5 but also the OATS data on trading in Nasdaq securities and the audit trail data the NYSE gathers. That further evaluation should consider whether the trade throughs the Commission believes it found during the period covered by the OEA study were in fact trade throughs or instead were false positives occasioned by locked and crossed markets, race conditions, and the impact of "reserve" and replenishment.

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We appreciate the opportunity to present our views to the Commission. If members of the Commission or the staff wish to discuss our comments, please call either me (617-563-7000) or our counsel, Roger D. Blanc (212-728-8206).

Respectfully submitted,

cc (w/att.): The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
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