ROSENBLATT SECURITIES INC.

January 26, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

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

Dear Mr. Katz:

As market participants we all have an obligation to consider and discuss the SEC's proposed changes not from a self-interested perspective, but from a public policy perspective. We believe that we have been able to do this in as unbiased a fashion as possible being an agency-only broker dealer who only represents the public, does not trade for its own account and actively trades both listed and OTC stocks as an NYSE member, ArcaExchange member and market participant in all major ECNs.

Consistent with that perspective and that duty, we have tackled the SEC's voluminous re-proposal of Reg NMS. However, before giving our comments, we first want to take a moment to commend the SEC and its staff not only for the sheer amount of work obviously put into this effort, but also specifically on a number of achievements, namely: (i) setting forth the rationale behind protecting and encouraging limit orders and also seeing through specious arguments and statistics presented by certain parties opposing the trade-through rule for self-serving reasons,[1] (ii) recognizing the need to apply investor protection principles uniformly across all markets,[2] (iii) eliminating any unfair advantage a manual market might have over an electronic market by restricting trade-through protection to automated, immediately accessible quotes only, but wisely abandoning the ability to

---

1 In particular, we applaud the efforts taken by the Commission and staff to dissect the "flawed" execution quality statistics submitted by certain ECN commenters and thereby dispel popular myths promoted by them. The most notable conclusions were that (i) disparities between Nasdaq and NYSE effective spreads disappear when one controls for differences in stocks, order types and order sizes, e.g. by measuring in basis points rather than cents per share, reflecting the fact that the average NYSE-listed stock price is higher than that on Nasdaq, (ii) Nasdaq experiences very low fill rates for larger marketable limit orders and thus certainty of execution (as opposed to speedy response times) is actually "not a strength of the current market for Nasdaq stocks", (iii) Nasdaq stocks experience "significantly higher" transitory volatility (*i.e.*, short-term fluctuations in price that are independent of earnings reports, news, etc.) than NYSE stocks, and (iv) Nasdaq actually experienced a significant percentage of trade-throughs (2.5% of all trades, 7.9% of all volume).

2 We note that while we have never advocated the trade-through rule's extension beyond ITS participants to Nasdaq-listed stocks *per se*, we have always believed that uniformity of regulation is generally the fairest and most sensible path to follow so long as there is no compelling reason to deviate from such consistent rule application (this same logic applies to the reform of the short sale rule incidentally).

opt out since it is unnecessary under such a fast quote/slow quote formulation, (iv) addressing impediments to efficiently functioning markets such as sub-penny pricing, flickering quotes and frequent locked markets that were unintended consequences of decimalization and the proliferation of electronic markets, and (v) perhaps most importantly, stepping back from what appeared to be (at least from rumors in the press) a move towards a decision to make a revolutionary change in Reg NMS's treatment of trade-through without further public comment. We firmly believe that sunshine is central to the regulatory oversight process and ultimately to the efficiency of our capital markets. Accordingly, we particularly appreciate the SEC's decision to offer the public an opportunity to specifically comment on the merits of the Market BBO Alternative that would protect only the best bid and offer at the top-of-the-book and the Voluntary Depth Alternative that would protect bids and offers throughout the entire depth-of-book (DOB).

In the re-proposal, the SEC has specifically sought public comment on which of these two alternatives is likely best to advance the *principle of limit order protection* while *avoiding practical implementation problems* and *preserving inter-market competition*. We might also add *avoiding unintended consequences* to this list of goals for Reg NMS. While admittedly there is some logic on the surface to the argument that if top-of-book is good for the markets (a premise which we accept), then extending it to depth-of-book should be even better. This not the case, however, because the DOB alternative does not achieve the goals set out by the SEC. While the DOB alternative obviously intends to protect limit orders even further than today's trade-through rule, ironically we believe that limit orders might actually become less prevalent under this formulation. We also believe that the DOB alternative if implemented will inhibit inter-market competition, have potentially serious unintended consequences in the form of increased fragmentation and internalization and have a very big practical implementation problem in that it fails to address fundamental realities of the marketplace such as front-running and market impact that explain why institutions usually choose to hide their intentions today. Let us elaborate.

Refocusing on the Principle: A Look Back at the History and Rationale of Trade-Through

In order to examine logically the arguments presented by the SEC and other commenters regarding trade-through, we believe it is first worth re-visiting the basic assumptions behind the trade-through rule--who benefits, who is injured and what is its true value and to whom. While we have explored this issue in much greater depth in a previous piece we submitted to the SEC some time ago, http://www.rblt.com/articles/Debunking_the_Myths_of_the_Trade_Through_Rule.pdf, let's spend a moment on it again, as understanding where we've come from with respect to the rule is necessary to inform the debate of where we should be going.

In spite of the steady stream of misguided analogies proffered over the past several years (from coca-colas and cartons of milk to ice cream and loaves of bread purchased at nearby delis and far away supermarkets) twisting the debate to paint trade-through as an obstructionist rule protecting the NYSE's market share and arguing the free markets logic of granting a stock buyer and seller the right to transact wherever they want and at whatever price they want, the trade-through rule is and always has been a plain and simple investor protection principle. It does not address the party trading through a better priced bid or offer, nor the counterparty to that trade, nor either of their "rights" to trade freely. In addition, importantly, the trade comprising the trade-through itself is not even a rule violation. The trade-through rule speaks only to the investor who has improved liquidity and taken a risk by publishing the best bid or offer in a market center. Protection under the rule simply provides recourse for such individual traded through who may choose to withdraw his/her bid or offer or demand an execution from the party who traded through. It is only when this demand is made and the party who traded through refuses to comply with the injured party's request that a rule violation occurs.

Although both alternatives being considered by the SEC are still aimed at protecting limit orders, they both would change the historical theory markedly. A violation by the party trading through would still exist now whether or not the order that had been traded through subsequently requested an execution or not. It appears to us that this could create a regulatory nightmare of thousands of potential trade-through rule violations where no investor has really been disadvantaged. Here's why. The party trading through is either doing so accidentally (e.g. because of flickering quotes) or by design because he perceives it to be in the best interest of his customer, consistent with his best execution obligations. For example, he might have decided to quickly grab a 10,000 share offer instead of or before going out to another marketplace for 500 shares in the same stock offered there one penny cheaper. Today, the 500 share offer has the right to complain about being ignored, demanding an execution to make him whole. If he does not choose to exercise that right, it is hard to argue that there has been any economic harm to him.

In its discussion of the theory behind the trade-through rule in the original Reg NMS filing and in the re-proposal, the SEC clearly embraces this principle of investor protection, particularly when it discusses its role in protecting retail investors. However, even the SEC seems to fall into the trap on at least one occasion and looks at the wrong side of the equation, reflecting a common, fundamental misunderstanding of the trade-through rule. In this instance, a significant amount of time is spent calculating a loss of "$321 million in bypassed limit orders and inferior prices for investors in 2003 that could have been addressed by strong trade-through protection." Remember, it is the traded-through party that the rule is intended to protect and should be the sole focus, so it is not clear at all what economic harm is being measured here. The traded through party might ultimately have traded at its original limit price or better (which cannot be known), and at least with respect to the NYSE portion of this total, the trade-through rule would have given the traded-through party the right to complain and be made whole.

We believe that "criminalization" of trade-throughs, as some have termed the proposed automatic nature of the violation, is a mistake and introduces unnecessary inflexibility into the system without any real identifiable benefits to the traded through party, on whom the rule is solely focused and who already has a complaint mechanism. However, departing from this path does not seem particularly open for discussion, so we will focus the remainder of our comments on the DOB alternative and its drawbacks, informed by this background nevertheless.

Ignoring Reality: The Greatest of All Practical Implementation Problems

Much of the trade-through discussion in the re-proposal explores and requests comments about whether the DOB alternative can be implemented in a practical and cost-effective manner. Technical feasibility does not equate with desirable policy. The first question that must be answered then is whether the DOB alternative is desirable policy. We believe it is ill-advised and based on a fundamental misunderstanding of why institutions trade the way they do today.

Most liquidity is not in fact published. It is generated by agents in possession of large institutional orders negotiating and reacting to trading opportunities and capital providers, whether they are specialists on the floor of the NYSE or brokers reacting to specific client requests to provide liquidity. According to the SEC, the DOB alternative is a way of encouraging more liquidity to be exposed to the marketplace through limit orders. The motivation to do this would be the punitive potential of an order being ignored unless it is displayed when trading opportunities present themselves. This reasoning misses the point. The reason that investors don't currently display more of their investment intentions is that quotes have never been representations of total available liquidity. They are in fact tactical representations designed to safely attract contra side interest. Institutions typically like to act anonymously and leave as little footprint as possible, using limit orders only to attract liquidity rather than to represent their true interest. They (or their brokers representing them) often use reserve features on the ECNs—and soon, via their brokers, interest files on the NYSE. Alternatively, they frequently give orders to their brokers and traders on the floor and on trading desks, respectively, to "work", i.e. use their discretion to find liquidity. The DOB alternative would be trying to change the game and attempt to force institutional investors to do what they have already decided is not tactically nor safely in their best interest.

We do not believe that most institutions will all of the sudden change their approach to safe trading even if the DOB alternative is implemented. This means that a fiction will be created that pricing away from the inside market is real in some way and actually reflects a true balance of supply and demand, when everyone (with the possible dangerous exception of retail investors) knows that the bulk of liquidity is not exposed and is instead hidden in reserve or held by someone with more to do. In the end, the SEC would be misleading the public and putting its seal of approval on fictitious pricing by adopting the DOB alternative. And if the system encourages mispricing, we are all hurt. Punitive mispricing is certainly not in the public interest. The primary role of an SRO is to blend supply and demand to generate credible pricing. It is precisely price discovery perceived to be accurate and efficient that creates a safe environment for all investors and corporate equity issuers. The fact that the SEC has characterized the DOB alternative as voluntary for each SRO actually makes it worse, weakening the proposal further. Endorsing opposing philosophies of fair and efficient equity pricing simultaneously is simply asking for trouble. A bifurcated market—with retail investors and institutional investors trading in very different ways and interacting barely at all—is a possible result of the DOB alternative (as explained later) and its voluntary nature only exacerbates this risk.

In addition, the SEC specifically asked whether the reserve functionality that is currently a major component of the typical ECN business model and soon-to-be a significant component of the NYSE's hybrid initiative would *de facto* detract from the benefits of the DOB alternative. The answer is yes because as the SEC points out the continued operation of reserve features alongside DOB would result in frequent odd situations in which one market actually is permitted to trade at an inferior price simply because DOB only addresses *displayed* liquidity and not reserves, a major component of today's market structure.

If in fact we are to encourage greater visibility of the available liquidity in equities, it must not be done by punitive mandate. The dynamic nature of trading opportunities, as well as the fear of front running, market impact and the disappearance of available contra parties, are the main reasons liquidity providers do not display their intentions, and yet neither the SEC nor any of the comment letters we have read have suggested ways to encourage exposure by reducing these risks. It is in everyone's interest that we continue to pursue ways to avoid front running of investors' intentions, but how could we ever deal with limiting the contra side of the market from running for cover when they sense an imbalance of supply and demand? Smarter people than us will have to deal with that one. But until these issues can be resolved, the top-of-book protection comprising the BBO Alternative is really the only choice that makes sense.

Preserving Market Competition

On several occasions in the Reg NMS re-proposal, the SEC frames the overarching goal of our national market system (NMS) as furthering two distinct types of competition—competition among individual marketplaces and competition among individual orders—that together contribute to efficient markets by promoting the most efficient and innovative trading services and by integrating competition among orders that leads to the most efficient pricing of stocks. Balance is the key, the Commission argues, with the NMS trying to avoid isolated markets that ignore trading in other markets, fragment liquidity and reduce order competition and also avoid a completely centralized system that loses the benefits of vigorous competition and innovation among distinct marketplaces.

Accordingly, the SEC asked for comments on whether protecting DOB quotations would inappropriately limit the terms of market competition. We think DOB goes too far in the direction of centralization and will stifle innovation and eliminate the uniqueness of individual marketplaces by imposing *de facto* serious penalties on those who don't "voluntarily" follow the new structure. A marketplace that did not "voluntarily" choose to provide DOB quotations in a DOB-dominant world would be at a disadvantage and be possibly compelled to become a look-alike market. There is a reason that DOB and CLOB (the acronym for central limit order book, which eliminates all marketplaces but one) rhyme.

Further, the SEC asked whether the DOB might reduce the scope of competition among markets to the payment of liquidity rebates for executed limit orders. This is certainly a possibility. Firms with significant retail order flow raise the most concern in our view since their customers are generally considered more vulnerable to abuse and less sophisticated. High rebates may incent such firms to send limit orders to marketplaces that have lower fill percentages and/or slower fills. We believe that this risk may be potentially heightened further by another element of Reg NMS—its new market data revenue allocation formula to the extent it incorporates the amount of time accessible quotes spend at the best bid/offer. While we are by no means experts on market data fee issues and appreciate that the SEC was wisely attempting to address the inequalities of the current market data revenue sharing formula to disincentivize the trade shredding that the current formula has encouraged, we would nevertheless offer one potentially unintended consequence of the revised formula. In deciding to reward accessible quotes in addition to actual trades with market data revenue, it is possible that many firms with substantial customer order flow, particularly retail, will be incented to start new ECNs in order to have the opportunity to post quotes and collect market data fees, even if their customers suffer from slower executions and/or missed trades. We're not sure that the additional fragmentation from newly created ECNs and the potential impact on unsophisticated customers is being adequately considered on either the DOB or market data revenue sharing front. This is particularly troublesome and poses great risks since the SEC has such a large responsibility in this instance with sweep functionality being introduced to the retail investor for the first time.[3]

We have always believed the SEC's role is to encourage efficient markets and ensure investor protection throughout the process. New ideas and products have been supported by the SEC rather than generated by them. For example, the SEC supported the Amex's creation of ETFs in the 1990s, while in the 1970s it encouraged the establishment of the ITS connecting regional stock exchanges to the dominant NYSE and provided an avenue for fast, cost-free access to the NYSE for regional specialists trading for their own accounts. Similarly, when ECNs first came on the scene, the SEC provided them with an exemption from the firm quote rule. They could provide their bids and offers along side of other market participants but refuse to trade with anyone who would not pay them a fee. One might argue whether these competitive advantages really work or not or are the right ones, but the concept of providing the marketplace with the benefit of new market structure ideas by easing entry and affording early protection to new players makes all the sense in the world. In the past the SEC has enabled the SROs and our industry to experiment and serve as laboratories for new ideas and systems to compete with traditional methods. This is one of the primary reasons our capital markets have thrived and become the envy of the world. It would be a catastrophic mistake to shut down this process and mimic the homogeneity of the European electronic markets by creating a virtual CLOB. The timing is particularly inauspicious with the NYSE's imminent introduction of the first-ever hybrid equity market.

Unintended Consequences

We believe that there are two potential unintended consequences of the DOB proposal that have not been adequately considered. First, we believe that fragmentation would be a real risk under the DOB alternative. Because institutions do not desire to expose all of their orders as explained above, we believe that institutional orders will in fact actually be removed from the NMS rather than limit orders being encouraged. Crossing networks, foreign marketplaces and upstairs trading desks will be the likely beneficiaries. Liquidity will be further fragmented and orders will interact less, the opposite effect of what the DOB alternative intends. Retail investors may even lose the benefit of institutional-quality pricing if a bifurcated market were to develop because institutions choose to pull a significant portion of orders out of traditional exchanges and ECNs because DOB does not coincide with their view of trading strategy and tactics. Second, by creating the fiction that most available liquidity in the marketplace will be posted or exposed, the SEC would be putting its imprimatur on the mispricing that will inevitably result, and also encourage internalization and the abuse of retail orders. In fact, we fear some of the large broker-dealers advocating DOB may potentially use it as cover for massive internalization.

---

3 With respect to NYSE trading, recall that to date the ability to print outside of the best bid or offer has effectively only been available to the most sophisticated investors under Rule 127 (since it covered only block trades of at least 10,000 shares or $200,000 or more in market value, whichever is less). Accordingly, adding real sweep capability for retail investors ought to be considered very carefully.

Considering the kind words the SEC's proposal had for the NYSE volatility, effective spreads and fill rates relative to the Nasdaq and considering that the trade-through rule will be applied to the Nasdaq for the first time and the fact that the fast quote/slow quote (and the concomitant NYSE hybrid) are already major changes, why would the SEC risk squashing the NYSE's innovation and also not weigh the impact of these incremental, but major moves first before considering an even more radical step? The Hippocratic mantra of "do no harm" should be at the forefront of the SEC's considerations. Prudence and incremental steps seem like the obvious choice.

In closing, the importance of maintaining our country's preeminent position in financial services and constantly striving to reduce volatility and transaction costs, ensuring credible pricing, improving the overall efficiency of our capital markets and lowering the cost of capital cannot be underestimated as the SEC is obviously aware. Another way that the SEC has framed the issue is to balance the greatest possible interaction, or competition, among orders and the greatest possible competition among market centers. Unfortunately and somewhat ironically, in our view, the DOB alternative would seem to weaken both intra-market competition and inter-market competition by ignoring how and why the vast majority of trading happens today and therefore should be rejected.

Sincerely,

Richard A. Rosenblatt, CEO
Joseph C. Gawronski, COO

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth
Robert L.D. Colby