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Bill,

I wrote the attached some time ago but never did anything with it. It was an attempt to raise the debate from the competitive level to the public policy level. I thought it might be of interest to you as you continue to think about these important issues.

Best,

Bob

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A Fair Trade For Investors

RGB Draft 12/06/03

The breadth and depth of the U.S. capital markets is what distinguishes our economy from all others. Our capital markets have fueled the growth of America's great enterprises by bringing together investors and entrepreneurs, channeling capital to the most promising ideas.

And yet, as I write this, our capital markets have never been more challenged. Beginning with the bursting of the dot com market bubble of the late 1990's and followed by questionable practices on the part of some corporate officials, auditors, research analysts, investment bankers, mutual fund executives and securities dealers, investors have been the victim of what can only be described as a perfect storm. A storm that has dealt quite a blow to the trust and confidence so critical to the efficient functioning of our securities markets and, in turn, our economy.

It is against this background that the U.S. Securities and Exchange Commission will soon consider rules to reshape our Country's equity markets. These rules have the potential to significantly change the way stocks are traded and accordingly will be worthy of the attention of each of the diverse groups participating in the markets today. Corporations will want to satisfy themselves that proposed changes will not increase volatility in their shares and potentially increase their cost of capital. Investors and broker-dealers will want to examine any changes against their need for efficient and liquid markets providing superior prices and reliable low cost order execution services.

One change being considered involves moving away from price in favor of speed as the most important variable in executing investors' orders. This is said to be an attempt to better meld electronic markets, whose principal benefit is speed, with hybrid markets that offer a combination of best price and speedy executions. This scenario would license stock markets to ignore, or trade through, investors' better-priced orders in other markets, essentially uncoupling the nation's stock markets. The problem is that trade throughs inherently involve treating investors unfairly – never a good idea, and especially so in the current environment.

In order to foster competing markets on the one hand, while insuring that investors would not be disadvantaged by fragmented prices, Congress and the SEC "stitched together" competitive markets through 1) electronic linkages for order routing; and 2) a rule requiring those markets to respect each others' prices. The so-called trade-through rule is perhaps obscure but by no means arcane. If you have an order at the NYSE to buy XYZ at $20, and if it trades on the Chicago Stock Exchange, for example, at $19.90, then your order has been traded through. Simple as that. Under these circumstances, several things have happened: 1) the seller did not get the best price in the market; 2) more relevant to the trade-through rule, the highest bidder was ignored and did not get to purchase the shares; and 3) the trade-through resulted in the company's shares being mispriced.

The trade-through rule has protected investors by providing that a market that executes an order at an inferior price must satisfy investors displaying better prices in other markets. It has the practical--and desirable--effect of directing investors' orders to markets that offer the best prices and, in so doing, incents competition among markets to establish efficient prices.

Trade-throughs devalue price as an order execution element and weaken the equity pricing mechanism. They represent a disincentive for investors and traders to post better prices – and thereby provide liquidity to the marketplace -- because there can be no assurance that doing so will be rewarded. When competing to establish the best price is no longer the key to attracting orders, markets will regress to the lowest common denominator with respect to price. When one considers that the fundamental mission of a stock market is to efficiently price securities, how can the price at which investors trade not be paramount?

Trade-throughs are symptomatic of inefficient markets – indeed only an inefficient market could give rise to a trade through. They are a violation of the trust investors place in the market and inconsistent with any conceivable notion of fair dealing. While a few very large players may favor the ability to trade through to gain an advantage, that kind of thinking is what created the crisis in our capital markets in the first place.

The SEC ought not to simply dictate market structure. Ideally it should create a framework that allows markets to choose the combination of services they wish to offer and let investors decide which services --- and therefore which market(s) – best meet their needs. It should encourage well-functioning capital markets and highlight the importance of investor confidence in ensuring that result. Because in a world where trade throughs are sanctioned by the SEC – and therefore commonplace – how long will it take investors whose orders are ignored to lose confidence in the system's ability to meet their needs? How long before corporations experience a higher cost of capital due to decreased pricing efficiency and increased volatility in their shares? And, how long before the U.S. capital markets lose ground to foreign competition due to a decline in the efficacy of its pricing mechanism?

At the end of the day, the investor willing to buy for the highest price, and his counterpart willing to sell at the lowest price ought to trade. Anything else is not only counterintuitive, it's downright inefficient. Worse yet, it's anti-investor.